Study H-820 January 14, 2002

Memorandum 2002-7

Mechanic's Liens: Double Payment Issue (Comments on Discussion Draft)

This memorandum reviews comments we have received on the Discussion Draft concerning *Consumer Protection Options Under Home Improvement Contracts*, which was circulated after the November 30 meeting. The discussion draft presented two options: (1) a privity rule, limiting mechanic's lien and stop notice rights to claimants who have a contract with the homeowner, coupled with recognition of a right for claimants without a contract to seek an equitable lien on the owner's property to prevent unjust enrichment, and (2) a good-faith payment rule, limiting the liability of homeowners to the extent they have paid in good faith, but leaving existing mechanic's lien and stop notice remedies in place, applicable to amounts remaining unpaid. Both proposals would apply only to home improvement contracts under a certain cap based on the contract price — most frequently mentioned amounts are $10,000 or $25,000. The Commission also solicited comment on whether the cap should be based on the amount of the individual subcontractor's or supplier's contract, rather than the prime contract, and if so, what that amount should be. (Another copy of the discussion draft is attached for Commissioners.)

Attached to this memorandum is a staff draft of a recommendation on *The Double Liability Problem in Home Improvement Contracts*, which the staff proposes for submission to the 2002 Legislature to implement the Commission's recommendation on this topic. If the Commission gives final approval at the January meeting, the staff will revise the draft to reflect Commission decisions and seek introduction of a bill.

The following comments are included in the Exhibit:

Privity or Good Faith

As between the two proposals, Option 2 (protecting good-faith payment) received a higher approval rating than Option 1 (privity rule with equitable lien).

Joe Occhiuto, Robertson's Ready Mix, prefers the law as it is, but if a change is unavoidable, he would favor the good-faith option if it is revised to limit the protection where the homeowner has notice of a possible claim. (Exhibit p. 3.) Without this clarification, he would prefer the privity rule. Past attempts to implement a direct payment notice have not engendered much support.

Ellen Gallagher, Staff Counsel, Contractors' State License Board, believes the privity rule "should be rejected" and terms the good-faith payment rule as an "elegant, though limited, solution to the problem." (Exhibit p. 5.) As a technical matter in the privity option, she queries how the contract amount can be determined for purposes of applying the cap, since the work and materials of trade contractors and suppliers dealing directly with the owner would not be included in the home improvement contract. The staff doesn't think this should be a real problem. Under the privity approach, where the amount of the home improvement contract determines whether it falls under the cap, the only rights affected are those of claimants (subs and suppliers) who do not have a contract with the owner. Separate contracting or "withdrawal" from the home improvement contract would only reduce the amount of the home improvement contract and thus keep it under the cap. The question might arise, however, if the home improvement contract is over the cap, and a supplier decides to deal directly with the owner, thereby arguably lowering the home improvement contract below the cap. In any event, Option 1 anticipates that the cap is applied to the amount of the home improvement contract, whatever it is, and the other relationships occurring separately or later would not affect application of the cap.

H. Richard Nash, President of the Building Industry Credit Association, reports that the association board does not like either proposal. (Exhibit pp. 13-

14.) The board appears to dislike the privity option more than the good-faith option. Mr. Nash argues that the privity option would place the owner in the middle of disputes between the prime and subs and the prime would lose the ability to manage the project. Mr. Nash also is concerned that the provision that change orders do not affect application of the cap would enable the prime to leave items out and add them later, so as to do the homeowner a favor by keeping the project under the cap and thereby avoiding lien rights. This would only matter if the prime contractor doesn't pay subcontractors. A conspiracy between the owner and the prime to use the cap in this fashion would not be in good faith, so the owner would not be protected by the good-faith payment rule. Mr. Nash's concern could be avoided to a large extent by basing the cap on each subcontractor or supplier's contribution, rather than on the overall project. There may be other ways to address the potential for abuse by penalties, if it is a real concern.

As to the good-faith option, Mr. Nash sees the same opportunity for collusion and argues that a direct pay notice should be included as part of the statutory procedure, as discussed in the September tentative recommendation. (Exhibit p. 14.) The Commission has opted for simplicity, particularly following the reaction to the far more detailed mandatory bond proposal circulated in September. We have not detected any consensus on the desirability of a direct pay scheme, either recently or when the idea first surfaced. Of particular concern is the potential for abuse of the direct pay concept by its routine use. Several commentators have said that they would be likely to send direct pay notices out in the same fashion as preliminary notices. That concern led to the abandonment of the concept the first time it was discussed. The later proposal to limit the direct pay notice to cases where payment to the subcontractor or supplier was overdue was not well-received either.

Sam Abdulaziz views the privity rule as essentially abolishing the lien. (Exhibit p. 15.) This conclusion is based on the assumption that current business practices would remain unchanged and that the market would not respond in any way to a new allocation of risk. As to the good-faith option, Mr. Abdulaziz thinks it "might be an acceptable alternative" if a direct pay notice is included "requiring the owner to pay the subcontractor / material supplier first, rather than the prime contractor." (*Id.*)

James Acret reaffirms his support for the privity approach, which he originally proposed. (Exhibit p. 1.) He believes it is simpler than the good-faith

option, would avoid the need for the "intimidating 20-day preliminary notices," and "would relieve homeowners of the need to introduce evidence of good faith payment in order to remove mechanics liens from their title and thus enable them to sell or refinance their property without going to trial." (Exhibit p. 1.) If the good-faith rule is adopted, Mr. Acret would prefer that the rule be phrased not in terms of the owner's liability, but rather as follows: "The aggregate amount of all mechanics liens and stop notices that may be enforced against a home improvement project shall not exceed the amount earned by and remaining unpaid to the original contractor." (For the language suggested by the staff, see draft Section 3113 in the attached draft recommendation.

Norm Widman, Dixieline Lumber Co., dislikes the privity concept and notes that prime contractors "don't want anyone, subs or suppliers, messing with his customer." (Exhibit p. 11.)

Amount of Cap

Past discussions make clear that subcontractors and suppliers would like to see a cap set as low as possible. (See, e.g., Exhibit pp. 3.) H. Richard Nash, President of the Building Industry Credit Association, suggests a $10,000 cap based on the entire contract amount. Sam Abdulaziz declines to propose an amount, but writes, "if the cap were small enough, we would not loudly object based on a cost/benefit analysis." (Exhibit p. 15.)

James Acret prefers the largest cap possible, since he believes that "homeowners should be protected against large claims as well as small ones." (Exhibit p. 1.) He finds that a $10,000 cap based on the amount of the project would have no practical effect, as claims of individual claimants would not be worth pursuing anyway. He would prefer a cap applied to the value of the work or materials supplied by the claimant. This would also solve the problem of how claimants would know whether the cap was applicable to the job. (This issue is discussed below.)

Frank Collard, Credit Manager at Catalina Pacific Concrete, suggests that the cap should not exceed the amount of the license bond. (Exhibit p. 4.) Norm Widman, Dixieline Lumber Co., makes a similar proposal and suggests that the cap could be indexed to the license bond, perhaps set at twice the bond. (Exhibit p. 11.) The bond amount is currently $7,500 ($10,000 for swimming pool contractors). This is an interesting idea and should be seriously considered if the Commission decides to base the cap on each subcontractor's part of the project.

Of course, suppliers aren't regulated and licensed, so the logic breaks down at that point. It would also be possible to set a total contract cap by using a multiplier of the license bond amount.

Ellen Gallagher recommends setting the cap at $25,000 to provide increased protection over the $10,000 amount that has been discussed in past meetings. (Exhibit p. 5.)

Type of Cap

Applying the cap to the whole contract at the outset is the simplest option to understand and administer, leaving aside the burden on subcontractors and suppliers to determine whether the cap applies. There is also one rule applicable to the job in this situation, whereas if the cap applies to each subcontract, some may be under the cap and some over. This doesn't matter if there are no payment problems arising under the home improvement contract, but if some claimants are not affected by the good-faith rule and other are, what is the result?

Assume a statutory scheme with a $7,500 per claimant cap (the same as the general license bond): a supplier furnishes $5,000 worth of lumber, a carpenter contracts for $8,000, and a plumber contracts for $7,000. The prime contractor's markup is $2,000, for a total of $22,000. If the owner pays the prime contractor in full, but the prime does not pay the subs and supplier, in this example the carpenter would be able to enforce a mechanic's lien against the owner for $8,000, but the lumberyard and plumber would have no claim against the owner's property. This apparent inequity is not as unfair as it may seem, because the business people in question should know the risk they are assuming and could take appropriate steps or refuse to do business on that basis.

In the above example, what happens if changes and extras are allowed to affect application of the cap? If the plumber contracted for $1,000 in extras, he would be free of the cap, and could take advantage of the double liability of the owner, assuming notices had been given in a timely fashion. This seems arbitrary, particularly since the owner is unlikely to be aware of the consequences of the $1,000 in extra work. The prime contractor and subcontractor are more likely to know when the cap is exceeded than the owner, and yet they would bear no risk or responsibility in the matter. Furthermore, the subcontracting plumber would welcome the change that pushed the subcontract over the cap because the good-faith payment protection would no longer apply.

This analysis suggests that allowing changes to push over the cap is a greater evil than the contrary rule, and would undermine the intent of the good-faith rule.

Finally, in this example, if the owner stops paying the prime contractor after paying $18,000 (out of the total contract amount of $22,000), because she learns that the prime is not paying subs and suppliers, there would be another mix of results. The lumberyard, being under the cap, would have only the right to share in the part remaining unpaid ($4,000). The plumber would be in the same situation. Their combined $12,000 in claims would have to be satisfied pro rata out of the $4,000 liability limit on the mechanic's lien. The carpenter, who is not subject to the good-faith limitation, would be able to enforce a lien for the full $8,000. Remember also that payments to the prime contractor are not matched to work done. If changes had pushed the plumber over the cap, as before, the plumber joins the carpenter, leaving more for the lumberyard. In this case, the homeowner would be subject to paying $5,000 in lien claims to the lumberyard (since the change in the plumber's subcontract increases the total contract amount to $23,000, leaving $5,000 unpaid. This is the same result as if there were no cap at all, since those over the cap would be able to coerce double payment, while the supplier subject to the cap would, in this example, be able to get full satisfaction for amounts not yet paid.

These complications suggest that it is best to based the cap on the whole contract or to dispense with the cap and apply the good-faith rule to *all* home improvement contracts. The Commission may conclude that neither type of cap can be administered effectively and recommend protecting all owners entering into home improvement contracts from having to pay twice.

Treatment of Extras and Change Orders in Applying a Cap

A challenge of implementing a cap amount, whether based on the whole amount of the home improvement contract or each claimant's contribution, is to make the amount certain and determinable. Changes or extras added after the contract or subcontract is executed cause uncertainty if the application of the cap is re-evaluated each time there is a change in the project. (Some of the difficulties are illustrated in the preceding examples.) The December discussion draft opted for certainty, by making clear that the cap was determined without regard to any changes. However, some commentators think this provides an opportunity for manipulation. It is suggested that to avoid liens, the prime contractor will “do the owner a favor” by keeping the total under the cap, and then add the rest of

the job as extras after the cap is locked in. (See Exhibit p. 14.) Sam Abdulaziz writes that "to disregard extras or change orders allows for a great deal of shenanigans between the prime contractor and the owner (the people who need the least protection)." (Exhibit p. 15.) He does not elaborate. For the record, the staff disagrees that homeowners are among the "people who need the least protection."

Other Comments

The Exhibit to this memorandum includes some correspondence not directed toward the issues raised in the discussion draft. We note these issues briefly below.

Releases and Joint Checks

Tina Rasnow, Coordinator of the Self-Help Legal Access Center, Ventura County Superior Court (responding to a request to the Larry Doyle at the State Bar for comments from the legal services sector), would like to see more use of releases and joint checks. (Exhibit p. 2.) Ms. Rasnow expresses concerns with delay and lack of notice in the Contractors' State License Board arbitration program.

Better Notices

Ellen Gallagher, Staff Counsel, Contractors' State License Board, suspects that "true lien reform seems to be slipping away," and lists some additional steps she is recommending to the Contractors' State License Board. (Exhibit p. 6.) She includes a draft "Mechanics Lien Warning" intended to give homeowners better notice of their risks and remedies at the outset of the project, which would replace the "incomprehensible Notice to Owner." (See Exhibit pp. 7-8.)

Unintended Consequences

H. Richard Nash, President of the Building Industry Credit Association, suggests that trying to improve credit assessment in the construction industry will put marginal subcontractors out of business, "thereby eliminating competition and raising the cost of construction." (Exhibit p. 13.) On its face, this argument would support removing *all* regulation, thereby increasing competition and lowering the cost of construction. Nor is it apparent how either the privity option or the good-faith payment option affect the "framing contractor who is … a sole proprietor living in an apartment and leasing a pickup truck and … relying

on the funds from the job to pay for the material." Underlying Mr. Nash's comment would seem to be recognition that there really is a double payment problem, because the effect of the two options would be to eliminate that potential. If there is no double payment problem, why would elimination of the option to doubly charge the homeowner negatively affect the framing contractor described by Mr. Nash?

Earlier 50% Payment Bond Proposal

Ken Ferrari, Controller at Fairway Builders, Inc., has written concerning the 50% mandatory bond proposal circulated in the September tentative recommendation. (Exhibit p. 9.) Mr. Ferrari thinks the problem is that homeowners choose less qualified contractors and get what they pay for. He argues that questionable contractors who do not follow the law now would not follow any new law either. The 50% mandatory bond proposal was designed to be self-enforcing because subcontractors and suppliers would not have had lien or stop notice rights against the owner's property (to the extent of good-faith payments), thereby giving them an meaningful incentive to make sure the prime contractor had the bond. A similar engine drives the simplified (bondless) good-faith proposal currently under consideration. If subcontractors and suppliers are not willing to rely on the creditworthiness of their customer (the prime contractor or higher-tier subcontractor), then it is their option to take protective steps or accept the risk. Mr. Ferrari also suggests that more aggressive policing by the Contractors' State License Board is in order.

Written Contract Requirement

Norm Widman, Dixieline Lumber Co., San Diego, suggests that prime contractors should not be able to enforce payment against an owner unless the home improvement contract is in writing, as required by law. (Exhibit p. 11.) He argues that homeowners would learn not to pay the prime contractor if there is no written contract and then would have money to pay subcontractors and suppliers. The staff does not believe this addresses the double liability issue, although it would help enforce the written home improvement contract requirement. See Bus. & Prof. Code § 7159. This could be part of a broader reform package, or would be appropriate for a CSLB-sponsored bill.

Staff Recommendation

In an attempt to move the final Commission recommendation forward, we have attached a staff draft recommendation implementing the good-faith rule tied to a total contract price cap. The staff proposes this draft as the final recommendation on the double liability issue, subject to whatever substantive and editorial revisions the Commission desires to make. If the Commission wants to postpone adoption of the text of a final recommendation until a later meeting, we would use this material, revised to implement decisions at this meeting, as background for the bill that we anticipate will be amended to implement the Commission's recommendation.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

From: "James Acret" <jacret@gte.net>
To: "Stan Ulrich" <sulrich@clrc.ca.gov>
Subject: Comment to Discussion Draft
Date: Sun, 30 Dec 2001 21:48:11 -0800

CONSUMER PROTECTION OPTIONS UNDER HOME IMPROVEMENT CONTRACTS

Comment to Discussion Draft

I support the efforts of the Law Revision Commission to provide protection to consumers against unfair mechanics liens and stop notices. Both option 1 (privity rule) and option 2 (good faith payments) would afford some protection, and either option would improve things for consumers.

Option 1 is much preferable:

1. It would simplify the law while option 2 would complicate it.
2. It would relieve homeowners from receiving, and claimants from sending, the intimidating 20-day preliminary notices.
3. It would relieve homeowners of the need to introduce evidence of good faith payment in order to remove mechanics liens from their title and thus enable them to sell or refinance their property without going to trial.

Since I believe that homeowners should be protected against large claims as well as small ones, I would prefer the largest cap that would be approved by the legislature. The cap should apply to the value of the work or materials to be supplied by the claimant, rather than to the cost of the overall project.

The cost of recording a mechanics lien or filing a stop notice is trivial, but the expense of filing a foreclosure or enforcement suit discourages claimants from pursuing claims that are worth less than $10,000 because attorneys fees are likely to exceed any possible recovery. If a $10,000 cap were to be applied to the cost of an entire project, the only claims that would be eliminated would be those that likely would not be pursued anyway. A typical home improvement project costing $10,000 could be composed of $2,000 for plumbing, $2,500 for electrical, $1,500 for tile, and $4,000 for carpentry. None of these claims would be worth pursuing in court and therefore a $10,000 cap applied to the cost of the project would have no practical effect.

In order to afford an appreciable benefit to homeowners any cap should be applied to the value of the work or materials supplied or to be supplied by the claimant. An advantage of this approach to the claimant would be that a claimant would always know whether its work and materials were eligible for lien with no need to ascertain the cost of the entire project.

If the good faith payment approach is to be adopted, I would propose that it speak not in terms of limiting the "liability" of an owner but rather as follows:

The aggregate amount of all mechanics liens and stop notices that may be enforced against a home improvement project shall not exceed the amount earned by and remaining unpaid to the original contractor.

This approach would recognize that a property owner has no personal liability to pay mechanics liens. Owners pay off mechanics lien claims not to satisfy a personal liability, but to avoid foreclosure.

Date: Mon, 07 Jan 2002 10:12:31 -0800
From: "Tina Rasnow" <Tina.Rasnow@mail.co.ventura.ca.us>
To: Larry.Doyle@calsb.org, mbaker@co.la.ca.us
cc: sulrich@clrc.ca.gov, Bonnie.Hough@jud.ca.gov,
"Carmen Ramirez" <Carmen.Ramirez@mail.co.ventura.ca.us>,
"Greg Brose" <Greg.Brose@mail.co.ventura.ca.us>,
"Mike VanSickle" <Mike.VanSickle@mail.co.ventura.ca.us>
Subject: Re: Fwd: Mechanic's lien issues

Here are my thoughts regarding proposed changes to the law governing Home Improvement Contracts and Mechanics Liens:

In the SHLA Centers we see homeowners hurt because their payment for labor and materials was not passed on from the general contractor to the sub or supplier, but we also see small subcontractors and suppliers hurt because they were not paid by the general contractor. We tend to see more homeowners hurt than small subcontractors/suppliers, but both classes of folks are vulnerable to abuses by the general contractors.

My approach to providing consumer protection would be to require the general contractor to obtain material and labor releases as a condition of getting paid by the homeowner, and to further require in the home improvement contracts that the homeowner be instructed to issue joint checks payable to the general and the subs, and condition payment on the general providing signed conditional or final labor and material releases. Since the general contractor is expected to know the law as a condition of being licensed by the State Contractor's License Board, and since they are bonded to provide property owners with some minimal protection in the event the licensee violates the law, it makes the most sense to put the onus on the contractor to protect both the homeowner and the small subs, laborers, and suppliers, than to expect these other folks to be able to protect themselves.

I would also like to see something done to protect homeowners from abuses in the State Contractor's License Board's arbitration program. We have seen folks who submitted their dispute with their contractor to the License Board, only to have it drag on for two years and then discover that a hearing was held without notice to the property owner, and the result is binding on them. Due process apparently is at times ignored, and folks are losing their right to go to court by participating in a program that promises prompt, fair results, but delivers neither.

Anyway, those are my thoughts for now. Please let me know if there is anyway I can help further with this effort. Thanks for your consideration.

Regards,

Tina Rasnow, Coordinator
Self-Help Legal Access Center
Superior Court, County of Ventura
800 South Victoria Avenue, Room 106
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(805) 654-3879
FAX (805) 654-5110

Date: Mon, 07 Jan 2002 14:12:24 -0800
From: Joe Occhiuto <joeo@rrmca.com>
Subject: Mechanic's Lien, Double Payment Protection Options
To: "'Stan Ulrich'" <sulrich@clrc.ca.gov>

Dear Mr. Ulrich,

It is my understanding that you are seeking industry input as to a preference between two proposed approaches which are being considered to deal with protection from the harm of double payment in the context of construction projects, (i.e. the equitable lien vs the good faith payment discharge) . Please accept the following as the comments of Robertson's Ready Mix (Robertson's).

As a supplier of material who often has to resort to the mechanic's lien remedy in order to be paid Robertson's does not support either version and prefers that the law remain as is. If a change in the law is unavoidable Robertson's prefers the good faith payment limitation, but only if the proposed legislation is amended to make clear that that the good faith payment limitation shall NOT be made available to the extent a payment was made subsequent to the home owner having knowlede of identity of a potential claimant, irrespective of the source of the knowledge and whether or not the the original contractor had knowledge independent of that obtained from the home owner. It seems equitable that once the home owner has notice of a possible claim that he/she should act in a manner consistent with the claimant's interests, since the claimant's labor/material is being used to improve the home owner's property. Absent the proposed clarification Robertson's prefers the equitable lien approach.

Robertson's prefers that the value limit of home improvement contracts, as to which the mechanic's lien remedy would be restricted, be as small as possible.

Thank you for your consideration of the foregoing.

Joe Occhiuto

From: "Collard, Frank" <fcollard@calportland.com>
To: "'Stan Ulrich'" <sulrich@clrc.ca.gov>
Date: Mon, 7 Jan 2002 15:36:36 -0800

Dear Stan and The Members of the Commission:

Re: Double Payment Protection Options

After sitting in on the November 30, 2001 CLRC meeting and hearing the discussion on the two options, I am still not convinced this is needed. However, if the Commission is looking for comment on the two drafts I feel very strongly only option 2 - Limited Protection For Good-Faith Payments should be considered.

Full payment is an easily understood concept and simple to prove well ahead of ever filing of a lien. In my opinion, it is quite illogical to introduce new concepts such as "privity and equitable lien" to this one small segment of lien law and contract rights area. It is by testimony and in reality a very small problem. Why make it more complicated to the homeowner and small contractor.

The cap on the dollar amount should also not be above the dollar amount of the license bond. This special exclusion to the lien law is going to make it harder for the new contractor to start into business. I also fear it will increase work performed by unlicensed contractors as homeowners may falsely assume contracts in this smaller dollar range are not covered by the law. This exclusion should not include use of unlicensed contractors.

Thank you for your time in reviewing and researching this issue. Also, I am looking forward to the information and discussion on the general revisions to the Mechanics' Lien law.

Sincerely,

Frank Collard
Credit Manager for CATALINA PACIFIC CONCRETE

CONTRACTORS STATE LICENSE BOARD
9821 Business Park Drive, Sacramento, California 95827
Mailing Address: P.O. Box 26000, Sacramento, CA 95826
800-321-CSLB (2752) or 916-255-3900
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STATE OF CALIFORNIA
Gray Davis, Governor

January 8, 2002

Mr. Stan Ulrich
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road
Room D-1
Palo Alto, California 94303

Dear Mr. Ulrich:

Re: **Mechanics= Liens**

**************VIA E-MAIL**************

Thank you for your latest proposal. The Contractor's State License Board (CSLB) has not met since your new recommendations became available and has not reviewed these approaches so I cannot tell you how the Board will respond to these proposals. I can tell you, however, that I will recommend to the Board that they support option 2, the good faith payment approach. While it cannot be said to create sufficient consumer protection for California homeowners, it is a start.

The first option—the limited privity rule—should be rejected. It turns CSLB home improvement contracting on its head. It creates more problems than it solves by blurring the responsibilities between prime contractors and subcontractors and suppliers. It also creates new contractual relationships and attendant responsibilities for homeowners beyond their expertise. If the subcontractors and suppliers contract directly with the homeowners, how can their work and materials be included in the prime's contract? But if they are not included, how can you tell if the contract is a $10,000 (or $25,000) contract?

The limited protection of good-faith payments approach is, however, an elegant, though limited, solution to the problem. A homeowner who pays in good faith should not be subject to mechanics' liens. I would recommend placing the contract amount at $25,000 to provide increased consumer protection. Contracts larger than $25,000 will probably take longer and, from a lien perspective, will be simpler to manage.

Because true lien reform seems to be slipping away, I began work on a few additional ways CSLB can help homeowners, as follows:

- Revise the incomprehensible Notice to Owner as a more user-friendly Mechanics' Lien Warning. I have begun circulating this proposed change to industry and consumers (See Attached).

- Propose changes to B&P Code section 7159 to require prime contractors to address the issue of mechanics' liens with their homeowner clients.

- Create the consumer pamphlet, "Don't Lien on Me." The pamphlet would describe not only the lien process but also how to determine if the lien is valid and how to remove it if it is invalid. Many homeowners pay invalid liens.

Thank you for the opportunity to participate in this process. If you have any questions or want to talk, please call me at 916-255-4116 or send me e-mail at EGallagher@dca.cslb.ca.gov.

Sincerely yours,

Ellen Gallagher, Staff Counsel
Contractors State License Board

cc: Stephen P. Sands, CSLB Registrar
Larry Booth, Vice Chair, CSLB

"MECHANICS LIEN WARNING

Anyone who helps improve your property but is not paid may file what is called a mechanics' lien on your property. A mechanics' lien is a claim—like a mortgage or home equity loan—made against your property and filed with the county recorder.

Even if you pay your contractor in full, unpaid subcontractors, suppliers and laborers who helped to improve your property may file mechanics' liens. If a court finds the lien is valid, you could be forced to pay twice or have a court officer sell your home to pay the lien. Liens can also affect your credit.

To preserve their right to file a lien, subcontractors and material suppliers must provide you with a document called a "20-day Preliminary Notice." This notice is not a lien. The purpose of the notice is to let you know that the person who sends you the notice has the right to file a lien on your property if he or she is not paid.

Be careful. The Preliminary Notice can be sent up to 20 days after the subcontractor starts work or the supplier provides material. This can be a big problem if you pay your contractor before you have received all the Notices.

You will not get Preliminary Notices from your prime contractor or from laborers you hire directly. The law assumes that you already know they are improving your property.

Before paying the contractor for any work, make sure you have a lien prevention plan in place.

CHOOSE ONE OF THESE LIEN PREVENTION PLANS:

(1) Require your contractor to get a **PERFORMANCE AND PAYMENT BOND** or a **PAYMENT BOND** of 50% of the contract amount (not a contractor's license bond). The contractor should file the bond along with a copy of the home improvement contract with the county recorder. If your contractor gets one of these bonds, you will be protected from liens.

(2) **WRITE JOINT CHECKS**. When the contractor tells you it is time to pay for completed work, make sure you have waited long enough to have received all the Preliminary Notices and then pay with a check made out to both your prime contractor and the subcontractors or material suppliers who have sent you Preliminary Notices.

(3) **USE A JOINT CONTROL COMPANY**. For a fee, a joint control company can make sure that all possible lien claims are satisfied. Contact the CSLB for a list of companies providing this service.

(4) **PAY THE SUBCONTRACTORS OR SUPPLIERS DIRECTLY.** When your contractor tells you it is time to pay for the work of a subcontractor or supplier who has provided you with a Preliminary Notice, work out with the subcontractor and suppliers how much they are owed and match it with what the contractor says they are owed. Then pay the subcontractors and suppliers directly.

(5) **USE LIEN RELEASES.** You may require your contractor to provide you with unconditional lien releases from anyone who presents you with a Preliminary Notice. If you choose this method, contact the CSLB for its pamphlet on the lien release process or get the CSLB pamphlet from your contractor. The process is complicated and requires strict attention to detail.

IF YOU DO NOTHING, YOU RISK HAVING A LIEN PLACED ON YOUR HOME. This can mean that you may have to pay twice for goods and services or face the forced sale of your home to pay what you owe."

For more information, visit CSLB's website at www.cslb.ca.gov, call CSLB at 800-321-CSLB 2752), or write CSLB at P.O. Box 26000, Sacramento, CA 95826.

"Notice to Owner"

"Under the California Mechanics' Lien Law, any contractor, subcontractor, laborer, supplier, or other person or entity who helps to improve your property, but is not paid for his or her work or supplies, has a right to place a lien on your home, land, or property where the work was performed and to sue you in court to obtain payment.

This means that after a court hearing, your home, land, and property could be sold by a court officer and the proceeds of the sale used to satisfy what you owe. This can happen even if you have paid your contractor in full if the contractor's subcontractors, laborers, or suppliers remain unpaid.

To preserve their rights to file a claim or lien against your property, certain claimants such as subcontractors or material suppliers are each required to provide you with a document called a "Preliminary Notice." Contractors and laborers who contract with owners directly do not have to provide such notice since you are aware of their existence as an owner. A preliminary notice is not a lien against your property. Its purpose is to notify you of persons or entities that may have a right to file a lien against your property if they are not paid. In order to perfect their lien rights, a contractor, subcontractor, supplier, or laborer must file a mechanics' lien with the county recorder which then becomes a recorded lien against your property. Generally, the maximum time allowed for filing a mechanics' lien against your property is 90 days after substantial completion of your project.

TO INSURE EXTRA PROTECTION FOR YOURSELF AND YOUR PROPERTY, YOU MAY WISH TO TAKE ONE OR MORE OF THE FOLLOWING STEPS:

(1) Require that your contractor supply you with a payment and performance bond (not a license bond), which provides that the bonding company will either complete the project or pay damages up to the amount of the bond. This payment and performance bond as well as a copy of the construction contract should be filed with the county recorder for your further protection. The payment and performance bond will usually cost from 1 to 5 percent of the contract amount depending on the contractor's bonding ability. If a contractor cannot obtain such bonding, it may indicate his or her financial incapacity.

(2) Require that payments be made directly to subcontractors and material suppliers through a joint control. Funding services may be available, for a fee, in your area which will establish voucher or other means of payment to your contractor. These services may also provide you with lien waivers and other forms of protection. Any joint control agreement should include the addendum approved by the registrar.

(3) Issue joint checks for payment, made out to both your contractor and subcontractors or material suppliers involved in the project. The joint checks should be made payable to the persons or entities which send preliminary notices to you. Those persons or entities have indicated that they may have lien rights on your property, therefore you need to protect yourself. This will help to insure that all persons due payment are actually paid.

(4) Upon making payment on any completed phase of the project, and before making any further payments, require your contractor to provide you with unconditional "Waiver and Release" forms signed by each material supplier, subcontractor, and laborer involved in that portion of the work for which payment was made. The statutory lien releases are set forth in exact language in Section 3262 of the Civil Code. Most stationery stores will sell the "Waiver and Release" forms if your contractor does not have them. The material suppliers, subcontractors, and laborers that you obtain releases from are those persons or entities who have filed preliminary notices with you. If you are not certain of the material suppliers, subcontractors, and laborers working on your project, you may obtain a list from your contractor. On projects involving improvements to a single-family residence or a duplex owned by individuals, the persons signing these releases lose the right to file a mechanics' lien claim against your property. In other types of construction, this protection may still be important, but may not be as complete.

To protect yourself under this option, you must be certain that all material suppliers, subcontractors, and laborers have signed the "Waiver and Release" form. If a mechanics' lien has been filed against your property, it can only be voluntarily released by a recorded "Release of Mechanics' Lien" signed by the person or entity that filed the mechanics' lien against your property unless the lawsuit to enforce the lien was not timely filed. You should not make any final payments until any and all such liens are removed.

December 10, 2001

Design/Build
Residential•Commercial
Building Damage & Cost Analysis
Expert Witness Testimony
License No. 628821

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

RE: Proposed Legislation H820-MechanicsLiens

Dear California Law Revision Commission,

Please find attached a copy of a recent article concerning your proposed legislation with regards to Mechanic's Lien Law. While we are in support of protecting homeowners, we are strongly opposed to your recommended solution. Specifically, that the prime contractor be required to obtain a payment bond from a surety insurer in the amount of 50% of the contract price. We feel this is another case of the majority suffering due to the bad deeds of the minority. Undoubtedly, this will drive up cost in the industry as well as to homeowners while adding another layer of administrative bureaucracy to the system.

We feel that the root of the problem is a Homeowner who chooses a less than qualified contractor to do the work in order to save on cost. You get what you pay for! Adding cost to valid and reputable contractors which will be passed on to the homeowner, will only increase the likelihood of this problem. Questionable contractors do not follow the law and they certainly will not follow this proposed legislation. Instead, they will disregard the rules in order to save cost and make their bids more appealing. You cannot protect a Homeowner from selecting a questionable contractor in order to save on cost. We see it over and over again in our industry.

In order to reduce the problem, our industry needs to aggressively weed out shaky contractors by reducing bureaucratic costs thereby allowing good contractors to be more competitive. If license fees paid to the C.S.C.L.B. were not diverted (50%!) to the CA general fund, then there would be adequate funds to pursue and rid our industry of unlicensed and unscrupulous contractors. Please seek an alternative solution such as the prime contractor being required to offer the Homeowner a 50% bond of the contract price at the Homeowners cost.

Sincerely,

Ken Ferrari

Ken Ferrari
Controller

Encl.

California Mechanic's Lien Law Being Revised

California's mechanic's lien law is in the process of being revised. The California Law Revision Commission has been working for several years on the mechanic's lien law in general, and has recently focused its attention on "the double payment problem" in the area of home improvement contracts.

Home improvement contracts include all works of improvement undertaken on residential property (for example, any remodel or addition to any residential property would qualify). A double payment problem arises when the supplier or subcontractor is not paid, even though the homeowner has paid the prime contractor. The supplier or subcontractor may then record a mechanic's lien against the homeowner's property, forcing the homeowner to pay again in order to clear the lien.

The proposed legislation for home improvement contracts would provide greater protection for homeowners, limit the lien and stop notice rights of subcontractors and suppliers, and impose an additional bonding burden on prime (or original) contractors. The Commission is seeking public comment on the proposed legislation. Comments to the Commission are welcome.Comments should be received by the Law Revision Commission no later than November 15, 2001 to be considered.

Design professionals do not often record mechanic's liens, but architects, engineers, and land surveyors are all entitled to claim mechanic's liens under appropriate circumstances. A design professional having a direct contractual relationship with the owner is treated as an original contractor under the lien laws.

The recommendation of the Commission proposes that the prime contractor on a home improvement contract be required to obtain a payment bond from a surety insurer in the amount of 50% of the contract price. Whether or not a bond is obtained, the homeowner's liability would be limited to the contract price to the extent that payments had been made in good faith under the contract. The mandatory payment bond to be required of the prime contractor is intended to provide a fund to protect unpaid subcontractors and suppliers.

The payment bond would be required for all home improvement contracts in the amount of $10,000 or more. The failure of a prime contractor to obtain the required bond would subject the contractor to disciplinary action by the Contractor's State License Board. A deposit in lieu of a bond would not be sufficient to satisfy the requirements of the proposed legislation. The payment bond would be recorded before the job commences and the home improvement contract would be filed (not recorded) with the county recorder.

The current lien and stop notice rights would remain unchanged to the extent that the homeowner has not paid the contract price. The preliminary 20-day notice (the pre-lien notice) would not be required.

The proposed legislation is available from the California Law Revision Commission, 4000 Middlefield Road, Room D-1, Palo Alto, CA 94303-4739, or may be downloaded at the following link:

<http://clrc.ca.gov/pub/Study-H-RealProperty/H820-MechanicsLiens/TR-MechLienHIC.pdf>

As the proposed legislation for home improvement contracts currently stands, a design professional who contracts directly with an owner is a "prime contractor" and would be required to obtain a payment bond. Placing such a requirement on design professionals appears to be an unintended consequence of the proposed legislation. Exempting design professionals from the bonding requirement or restricting the bonding requirement to contractors who are subject to the Contractor's State License Law may be the most direct way to address this matter. Send your comments to Stan Ulrich at the California Law Revision Commission.

The need to obtain payment bonds for home improvement contracts may have general contractors reaching for their antacid tablets. It would not be a surprise if general contractors passed this cost along to the homeowner, raising prices for all home improvement contracts in order to address a problem which may not be very widespread.

by Mary Ann Egan

From: "Widman, Norm" <nwidman@dixieline.com>
To: "'Stan Ulrich'" <sulrich@clrc.ca.gov>
Subject: RE: CLRC Mech Lien supp
Date: Mon, 3 Dec 2001 16:00:15 -0800

[Widman, Norm] STAN,

VERY INTERESTING MEETING LAST FRIDAY. YOU ASKED FOR COMMENTS ON THE LIMIT AND SO I'M WRITING.

I BELIEVE THAT THE CEILING OF JOBS WITHOUT LIEN RIGHTS (UNLESS YOU HAVE PRIVITY WITH THE OWNER) SHOULD HAVE SOME RELATIONSHIP TO THE CONTRACTOR'S LICENSE BOND. CURRENTLY THE LICENSE BOND IS $7,500.00. IT IS VERY COMMON FOR THE LABOR ON A JOB AND THE MATERIALS FOR A JOB TO BE 50% EACH.

THEREFORE A $15,000.00 PER JOB CEILING COULD BE COVERED BY HIS LICENSE BOND IF THE CONTRACTOR GOES SOUTH WITH THE MONEY. IN THE FUTURE, THE CEILING COULD BE INDEXED TO THE LICENSE BOND AMOUNT.

I PERSONALLY DISLIKE PRIVITY AND I BELIEVE YOU WILL AWAKEN ALL 300,000 (SILENT SO FAR) SUBS AND PRIMES. PRIMES DON'T WANT ANYONE, SUBS OR SUPPLIERS, MESSING WITH HIS CUSTOMER.

Howard HAD THE RIGHT IDEA, PUT IN A CEILING AND ALLOW NO LIEN RIGHTS UNDER THAT AMOUNT. THAT WILL PROTECT THE HOMEOWNER UNTIL SOMEONE ATTEMPTS TO SHOW THAT THIS MAY BE UNCONSTITUTIONAL. NO NEED TO WRITE A LAW CONTAINING PRIVITY BECAUSE WE ALL(SUPPLIERS AND SUBS) KNOW WE CAN BE IN PRIVITY WITH THE OWNER IF WE WANT TO BE UNDER CURRENT LAW. NONE OF US USE THIS OPTION BECAUSE WE KNOW WE DON'T MESS WITH THE PRIME'S CUSTOMER.

MAY I COMMENT ON DIRECT PAY NOTICES WHICH WAS PART OF HOWARD'S IDEAS. ANY LAW CONTAINING WORDS ABOUT DIRECT PAY WOULD JUST FORCE US SUPPLIERS AND SUBS TO SEND DIRECT PAY NOTICES INSTEAD OF PRELIMS. DIRECT PAY NOTICES WILL STOP A HOMEOWNER FROM ANY GOOD FAITH PAYMENT DEFENSE.

LET'S USE THE MANDATE OF THE ASSEMBLY JUDICIARY COMMITTEE TO FIX DOUBLE PAYMENT BY CLEANING UP THE INDUSTRY WHICH CAUSES THE HOMEOWNER TO BE SUBJECT TO DOUBLE PAYMENT.

GIVE THE HOMEOWNER THE RIGHT TO KNOW THAT ANY CONTRACT NOT IN WRITING AND ON A HOME IMPROVEMENT CONTRACT IS ...(I DON'T KNOW THE LEGAL WORD. MAYBE IT IS VOIDABLE AND MAYBE IT IS UNENFORCEABLE OR MAYBE SOME OTHER WORD) THIS WOULD HAVE AN IMMEDIATE RESULT OF FORCING CONTRACTORS TO COMPLY WITH CURRENT LAWS DESIGNED TO PROTECT HOMEOWNERS.

I MENTIONED THIS AT THE MEETING AND HOWARD SAID "WOULD WE THE SUPPLIERS HAVE A LIEN?" I SAID YES, BUT I WOULD ACCEPT NO LIEN RIGHTS ON SMALL DOLLAR CONTRACTS WHERE THE HOMEOWNER WAS GIVEN A WRITTEN HOME IMPROVEMENT CONTRACT. IF THE HOMEOWNER WASN'T GIVEN A PROPER CONTRACT, SUBS AND SUPPLIERS WOULD HAVE A DIRECT CLAIM ON THE CONTRACTORS LICENSE BOND BECAUSE THE CONTRACTOR FAILED TO PUT THE CONTRACT IN WRITING AND VIOLATED BUSINESS AND PROFESSIONS CODE NUMBER..?

FOR YEARS WE HAVE DISCUSSED HOW THE HOMEOWNER NEEDS PROTECTION AND THAT THEY DON'T KNOW HOW TO PROTECT THEMSELVES. I BELIEVE THAT HOMEOWNERS WOULD VERY VERY VERY QUICKLY LEARN FROM THE MEDIA AND FROM THEIR FRIENDS THAT IF THE CONTRACTOR DIDN'T GIVE THEM A WRITTEN CONTRACT, THEY DID NOT HAVE TO PAY THE CONTRACTOR. IF THEY DIDN'T PAY THE CONTRACTOR, THEY WOULD HAVE MONEY AVAILABLE TO PAY SUBS AND SUPPLIERS. SUPPLIERS AND SUBS COULD BE ALLOWED LIEN RIGHTS ON JOBS OVER THE FLOOR OR CEILING.

IF THE INDUSTRY WAS CLEANED UP WITH AN EDUCATION/POLICING ACTION SIMILAR TO MY COMMENTS ABOVE, LIEN RIGHTS WOULD BE LESS IMPORTANT AS A COLLECTION REMEDY , HENCE VIRTUALLY ELIMINATING THE DOUBLE PAYMENT PROBLEM.

BICA
BUILDING INDUSTRY CREDIT ASSOCIATION
H. Richard Nash
President

January 10, 2002 VIA US MAIL AND FAX

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto CA 94303-4739

Re: Double Payment Problem – Commentary on December Discussion Draft

Dear Members of Commission:

I am writing this letter on behalf of BICA's Board of Directors in response to the December Discussion Draft regarding "Consumer Protection Options Under Home Improvement Contracts" as promulgated by the Commission for solving the Double Payment Problem. BICA is a membership organization made up of more than 800 companies who work in the building industry in southern California.

BICA's Board of Directors have a number of concerns with the proposals in the December Discussion Draft. Our concerns are as follows:

Discussion Period Too Short For Adequate Response
We believe that the current proposals warrant more time for study so that the industry can first understand the ramifications of these options and then respond. Having a response period of less than 30 days which includes the Christmas and New Years' holiday weeks limits input except from those immediately involved.

Adjusting Risk – Unintended Consequences
As stated in the Discussion Draft the two options would address the double payment problems by reallocating risk so subcontractors and suppliers would take more care in extending credit to their customers. How would this additional care be manifested? The extension of credit in the construction industry is unlike most other commercial credit transactions. Often subcontractors or general contractors do not have strong balance sheets showing assets which would justify the dollar amount of the transaction for which credit is being requested. How many banks would give a $15,000 loan to a framing contractor who (1) is a sole proprietor living in an apartment and leasing a pickup truck and (2) is relying on the funds from the job to pay for the material? Would construction industry credit managers begin to extend credit according to banker's standards? How many contractors would qualify under those standards? Would contractors with "low overhead" who are tremendous mechanics and craftsman be put out of business thereby eliminating competition and raising the cost of construction?

Option 1 – Limited Privity Rule
As proposed the privity rule would apply to home improvement contracts under a certain cap and would limit mechanic's lien and stop notice rights to claimants who have a direct contract with the homeowner. Change orders and extras would not affect application of

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the cap. If the homeowner does not pay, claimants without privity could seek an equitable lien.

This cure may be worse than the disease. What kind of confusion would there be if after the homeowner enters into an agreement with the general contractor to perform the work of improvement, subcontractors and suppliers step up and require direct contracts with the homeowner. If a supplier required privity and could not get it, a new supplier would have to be found. Where disputes may arise would not the homeowner be right in the middle and the general contractor lose his ability to manage the project. Furthermore, if change orders and extras do not affect the application of the cap, what is to stop the general contractor from "doing the homeowner a favor" by leaving out a portion of the work to stay under the cap and then adding that portion later as an extra. This increases the risk to the subcontractor or supplier because the job becomes bigger than the cap and they are left without lien rights.

Option 2 – Limited Protection for Good-Faith payments
The good-faith payment rule would protect homeowners by limiting their liability to the extent they have paid amounts due under the home improvement contract in good faith. Existing mechanics' lien rights would exist for amounts remaining unpaid by the homeowner. In the Tentative Recommendation, a "Direct Payment Notice" was provided for. We believe that Option 2 should contain that provision and it should allow Direct Pay Notices to be given by subcontractors and suppliers at any time in order to redirect payments.

The same problem exists here as in Option 1 whereby the general contractor can break the job down to contract amounts below the cap thereby eliminating lien rights where they otherwise would be available.

Cap on Contract Amount
We believe that a cap of $10,000 should be applied to the entire contract.

Constitutional Question
We believe that strong arguments can be made that the elimination of mechanics' lien rights caused by implementation of either of these two options would be unconstitutional. Where the mechanics' lien rights for the supplier and the subcontractor are eliminated, a time-tested remedy is denied to the industry. The Commission has admitted that the extent of the negative impact caused by the present mechanics' lien law on homeowners has yet to be established. In spite of that, this proposal is being pushed without considering the possibly LARGER specter of UNINTENDED CONSEQUENCES which could result from implementation of either of these options.

Respectfully submitted,

H. Richard Nash
President

Date: Sat, 12 Jan 2002 11:46:12 -0800
From: "Abdulaziz & Grossbart" <aglaw@earthlink.net>
To: "LAW REVISION COMMISSION" <commission@clrc.ca.gov>
Subject: RESPONSE TO LAW REVISION COMMISSION'S LATEST TWO ALTERNATIVES

January 12, 2002

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

RE: RESPONSE TO LAW REVISION COMMISSION'S LATEST TWO ALTERNATIVES

Dear Commissioners:

This letter is in response to the latest two alternatives wherein the Commission has requested comments. Although not noted in the latest Discussion Draft dated December 2001, the Commission decided at its last meeting, that it would not comment on, nor seek comment on, prior legal arguments such as the Constitutionality of its latest recommendations. In accordance with the Commission's position we are not commenting on constitutional arguments although we still argue that they are valid. We also believe all our other comments are still valid.

However, we cannot disregard the fact that the most recent Discussion Draft makes comments that are not admitted by many of the observers and commentators. Therefore the two proposals, which are allegedly supported by the comments, must fall in that they have no solid foundation.

The latest two alternatives are, 1) a Good Faith Payment Rule and 2) a Privity Rule. The Privity rule essentially does away with any mechanic's lien rights even if an equitable lien is placed in the statutes. To require unjust enrichment essentially abolishes the lien. If the owner pays the prime contractor, there can be no lien rights yet there is no protection for subcontractors and material suppliers.

With respect to the option of the good faith payment rule, this may be acceptable, depending on how the good faith payment is interpreted. That is to say that if subcontractors and material suppliers can send a notice to the owner requiring the owner to pay the subcontractor/material supplier first, rather than the prime contractor, then that might be an acceptable alternative.

Lastly, to disregard extras or change orders allows for a great deal of shenanigans between the prime contractor and the owner (the people who need the least protection).

With respect to the amount of the cap, we decline to propose any amount in that we believe any curtailment of lien rights is not appropriate. However, as I stated during the last Commission meeting, if the cap were small enough, we would not loudly object based on a cost/benefit analysis.

Very truly yours,

ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ

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#H-820

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

Staff Draft RECOMMENDATION

The Double Liability Problem in Home Improvement Contracts

January 2002

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739
650-494-1335 FAX: 650-494-1827

SUMMARY

The Law Revision Commission recommends special protections for homeowners who face potential double liability for labor and materials under home improvement contracts. This problem arises where the owner pays the prime contractor under the terms of their contract, but the prime contractor does not pay amounts due to subcontractors and equipment and material suppliers, who can then enforce their claims against the owner's property or construction funds.

After studying a variety of different options, the Commission has opted for a simple, easily understood and applied rule to protect the more vulnerable class of consumers from having to pay twice. The Commission recommends adoption of a good-faith payment rule, limiting the liability of homeowners to the extent they have paid in good faith, but leaving existing mechanic's lien and stop notice remedies in place, applicable to amounts remaining unpaid. Thus, mechanic's lien and stop notice rights of subcontractors and suppliers would not be affected to the extent that the homeowner has not paid in good faith for labor, supplies, equipment, and materials furnished.

The proposed law would apply only to home improvement contracts under [$25,000]. The application of this rule would be determined based on the amount of the home improvement contract as executed, without regard to any changes, extras, or other modifications occurring after execution.

This recommendation was prepared pursuant to Resolution Chapter 78 of the Statutes of 2001.

THE DOUBLE LIABILITY PROBLEM IN HOME IMPROVEMENT CONTRACTS

The Double Liability Problem

This recommendation addresses the double liability risk faced by consumers under home improvement contracts.[1] The double liability problem arises because, even though the owner has paid the prime contractor according to the terms of the contract, subcontractors and material suppliers are entitled to enforce mechanic's lien and stop notice rights[2] against the owner's property if they are not paid by the prime contractor.[3] The homeowner who pays a second time for the materials or the services of subcontractors has a justifiable grievance. But the homeowner is not the only victim in this situation, since the subcontractors and supplier have also not been paid and understandably will seek payment from the homeowner through enforcement of mechanic's liens or stop notice rights.

Homeowners may find out too late that their faith in the prime contractor was misplaced. The statute sets a trap through the "preliminary 20-day notice" under Civil Code Section 3097, which guarantees mechanic's lien and stop notice rights relating back 20 days before the notice is given. In smaller, quicker jobs, such as roofing, fencing, driveways, and the like, the homeowner is more likely to have paid most or all of the home improvement contract price before receiving any

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1. This recommendation is submitted as part of the Commission's fulfillment of a request from the Assembly Judiciary Committee to undertake a "comprehensive review of [mechanic's lien] law, making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions." See Letter from Assembly Members Sheila James Kuehl (Chair) and Rod Pacheco (Vice Chair) to Nat Sterling, June 28, 1999 (attached to Commission Staff Memorandum 99-85 (Nov. 16, 1999)). The Commission has long-standing authority from the Legislature to study mechanic's liens under its general authority to consider creditors' remedies, including liens, foreclosures, and enforcement of judgments, and its general authority to consider the law relating to real property. For the text of the most recent legislative authorization, see 2001 Cal. Stat. res. ch. 78.

The greatest part of the Commission's study of mechanic's liens has been consumed by the important consumer protection issue addressed in this recommendation. This proposal follows a Tentative Recommendation on *The Double Payment Problem in Home Improvement Contracts* (September 2001), which included a proposal for a mandatory 50% bond, coupled with the good-faith payment rule as in the present proposal. In light of opposition to mandatory bonding, the Commission tabled that part of the proposal and decided to take a simpler approach to address the problem.

The Commission is also preparing a separate report providing broader background on alternatives to address the double liability problem that have been discussed in the Commission's study.

The Commission also has plans to submit proposed general revisions of the mechanic's lien law. This study will require a significant commitment of time and resources by the Commission, its staff and consultants, and other interested persons, and thus will not be ready in the 2002 legislative year.

2. The mechanic's lien is governed by Civil Code Sections 3082-3267. As used in this recommendation, "mechanic's lien law" generally should be taken to include stop notice rights. The Contractors' State License Law also contains many important provisions governing contractors in the home improvement business. See Bus. & Prof. Code §§ 7000-7191, esp. §§ 7150-7168 (home improvement business).

3. See Civ. Code § 3123. A subcontractor may also be the defaulting party, failing to pay lower-tier subcontractors and suppliers.

notice. And then it is too late to avoid double liability if the prime contractor is insolvent or fraudulent.

Cautious homeowners, who take the time to learn the law and the available options, and are willing to spend money on additional protections such as joint control or bonding, can avoid paying twice. But not many homeowners take these extraordinary steps, especially in smaller projects. Because subcontractors and suppliers have mechanic's lien and stop notice rights permitting them to pursue payment even from homeowners who have fully paid the prime contractor, they have less incentive to follow standard business practices in evaluating the credit-worthiness of the prime contractor, much less take any special steps to protect their right to payment from the prime contractor.

The mechanic's lien law is unfairly balanced against the average consumer. It is natural for the homeowner to rely on his or her relationship with the prime contractor and to have confidence that payments under a home improvement contract are directed to the subcontractors, material and equipment suppliers, and laborers who have contributed to the project, in full satisfaction of the owner's obligations. If the prime contractor or a higher-tier subcontractor does not pay subcontractors and suppliers, the homeowner won't find out about it until it is too late to avoid some double payment liability and perhaps an incomplete project resulting in more costs.

Significance of Problem

The significance of this double payment problem is a matter of serious disagreement. There are no comprehensive statistics indicating the magnitude of the problem. Communications to the Commission suggest that actual mechanic's lien foreclosures are fairly rare, but foreclosures would only be the tip of the iceberg because homeowners would normally settle before suffering a foreclosure.

Assembly Member Mike Honda's office identified 61 double payment cases occurring over a three-year period, pulling information from a variety of sources.[4] Anecdotal evidence of a number of double payment occurrences has been presented to the Commission from individual homeowners and others, as well as from the Contractors' State License Board, although the Board does not necessarily receive reports of double payment and does not collect statistics in this category. In short, there is currently no good measure of the magnitude of the double payment problem. It is certain that when it occurs, it is considered a significant problem to the person who is compelled to pay twice for the same work or materials.

Several commentators have suggested that the double payment problem occurs so infrequently that it does not justify any major revisions in the mechanic's lien

4. See Commission Staff Memorandum 2000-9 (Jan. 31, 2000), p. 2.

statutes.[5] Some have suggested approaching the issue as one of educating the home improvement consumer so that he or she will know how to make sure subcontractors and suppliers are paid. Others believe that the problem is serious enough, even though it may be relatively uncommon, that some legislative response is needed.

Risk Allocation

The double payment problem may be viewed as a question of who should bear the risk of nonpayment by the prime contractor (or by a subcontractor higher in the payment chain) in a situation where the owner has paid, and which parties are in the best position to be knowledgeable about the risks and remedies and take the appropriate steps. Under the existing scheme, homeowners assume all of the risk associated with the failure of prime contractors to pay subcontractors and suppliers. This is counter to the normal expectations of how risk should be allocated in a marketplace.

A major defect that has been identified in the existing system is reliance on the homeowner to sort through the various notices and correctly anticipate the best remedy. Homeowners are likely to initiate few home improvement projects in a lifetime, whereas contractors and suppliers have daily experience in the business. This principle lies at the heart of consumer protection. Of course, there may also be significant inequalities in business and legal sophistication, bargaining power, financial soundness, and risk aversion among prime contractors, subcontractors, and suppliers, but as a class, those in the construction business and trades should be expected to have greater knowledge and sophistication about how things work than homeowners.

The scores of letters received in the course of this study, and remarks of persons attending Commission meetings, reveal problems with the operation of the home improvement marketplace. Work may be done without a written contract; credit checks are infrequent; Contractors' State License Board regulations are ignored or unenforced; sharp practices are not uncommon; payments are delayed or misdirected; subcontractors and suppliers continue to work with contractors even after experiencing payment problems. Facilitating many of these problems and temptations is the ability of subcontractors and suppliers to compel double payment from the homeowner. Where education, regulation, and policing won't work, perhaps only market forces can.

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5. See, e.g., Hunt, *Report to Law Revision Commission Regarding Recommendations for Changes to the Mechanic's Lien Law* [Part 2] (February 2000) (attached to Commission Staff Memorandum 2000-9 (Jan. 31, 2000)).

COMMISSION RECOMMENDATION

After a lengthy study of these issues, consideration of several alternatives, and a review of comments and criticisms of various experts and stakeholders,[6] the Commission is proposing an amendment of the mechanic's lien statute to protect homeowners from having to pay twice and thereby reallocate the risk in lower-priced home improvement contracts so that subcontractors and suppliers would need to take more care in determining the credit-worthiness of their customers or assume the risk of nonpayment.

The proposed law would apply to "home improvement contracts," as defined under the Contractor's State License Law,[7] under [$25,000].[8] Home improvement

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6. The Commission has been ably assisted by its consultants James Acret, Keith Honda, and Gordon Hunt who have prepared written materials and attended many Commission meetings. Mr. Hunt prepared written reports in the early stages of the project, bearing on the double payment issue as well as general reforms. See, e.g., Hunt, *Report to Law Revision Commission Regarding Recommendations for Changes to the Mechanic's Lien Law [Part 1]* (November 1999) (attached to Commission Staff Memorandum 99-85 (Nov. 16, 1999)) [hereinafter Hunt Report Part 1]; Hunt, *Report to Law Revision Commission Regarding Recommendations for Changes to the Mechanic's Lien Law [Part 2]* (February 2000) (attached to Commission Staff Memorandum 2000-9 (Jan. 31, 2000)) [hereinafter Hunt Report Part 2]; Hunt, *Report to Law Revision Commission Regarding Current Proposals Pending Before the Commission Regarding Changes to the Mechanic's Lien Law* (August 2000) (attached to First Supplement to Commission Staff Memorandum 2000-63 (Oct. 2, 2000)) [hereinafter Hunt Report Part 3]. Mr. Acret and Mr. Honda have also submitted numerous written materials. See, e.g., Commission Staff Memorandums 2000-9 & Second Supplement, 2000-26 & Second Supplement, First Supplement to Memorandum 2000-63, 2000-78. A number of other interested persons, some of them representing stakeholders in the construction world, have provided important assistance to the Commission, including Sam K. Abdulaziz, Peter Freeman, Ellen Gallagher (CSLB), Kenneth Grossbart. A complete list of persons attending Commission meetings relating to mechanic's liens can be compiled from the Minutes of the following meetings: November 1999; February, April, June, July, October, and December 2000; February, May, June, and November 15 and 30, 2001. Written commentary can be found in the exhibits to Commission meeting materials, available at the Commission's website at <http://www.clrc.ca.gov>. For a collection of all mechanic's liens materials, see <ftp://clrc.ca.gov/pub/Study-H-RealProperty/H820-MechanicsLiens/>.

7. Home improvement is defined in Business and Professions Code Section 7151:

> 7151. "Home improvement" means the repairing, remodeling, altering, converting, or modernizing of, or adding to, residential property and shall include, but not be limited to, the construction, erection, replacement, or improvement of driveways, swimming pools, including spas and hot tubs, terraces, patios, awnings, storm windows, landscaping, fences, porches, garages, fallout shelters, basements, and other improvements of the structures or land which is adjacent to a dwelling house. "Home improvement" shall also mean the installation of home improvement goods or the furnishing of home improvement services.
>
> For purposes of this chapter, "home improvement goods or services" means goods and services, as defined in Section 1689.5 of the Civil Code, which are bought in connection with the improvement of real property. Such home improvement goods and services include, but are not limited to, carpeting, texture coating, fencing, air conditioning or heating equipment, and termite extermination. Home improvement goods include goods which are to be so affixed to real property as to become a part of real property whether or not severable therefrom.

Home improvement contract is defined in Business and Professions Code Section 7151.2:

> 7151.2. "Home improvement contract" means an agreement, whether oral or written, or contained in one or more documents, between a contractor and an owner or between a contractor and a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, if the work is to be performed in, to, or upon the residence or dwelling unit of the tenant, for the performance of a home improvement as defined in Section 7151, and includes all

contracts are appropriate for special treatment under the mechanic's lien law because this class of construction contracts has been the focus of special Legislative attention for more than 30 years.[9] Employing other classifications, such as "single-family, owner-occupied dwelling," may also be appropriate, but it should be more straightforward to use an existing classification that is familiar to contractors and suppliers. Since home improvement contracts are required to be executed in a special form, it should not be difficult to determine whether the job is a home improvement project.

An owner who pays the prime contractor in good faith would not be subject to further liability. This rule is consistent with the common expectations of people who have not learned of the special "direct lien" rules applicable to mechanic's liens in California since 1911.[10] From the owner's perspective, common sense and fairness dictate that payment to the prime contractor pursuant to their contract should be the end of the owner's liability.

Protection of homeowners' good faith payments would leave existing mechanic's lien and stop notice remedies in place, but applicable only to the extent that amounts remained unpaid under the home improvement contract. Subcontractors and suppliers could thus continue to serve preliminary 20-day notices, but the mechanic's lien liability would be limited to amounts remaining unpaid, or in the rare case, amounts that were not paid in good faith. This rule would be an explicit exception to the so-called "direct lien" under existing law.[11]

Protecting homeowners under small contracts serves the fundamental purpose of providing a meaningful degree of consumer protection without complicated forms and technical deadlines. Setting a [$25,000] overall contract cap also recognizes that subcontractors and suppliers will rarely pursue the mechanic's lien remedy under existing law for smaller amounts because of the costs involved. The lack of recoverable attorney's fees in mechanic's lien foreclosure makes it impractical for a subcontractor or supplier to pursue collection for amounts under $5,000 or

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labor, services, and materials to be furnished and performed thereunder. "Home improvement contract" also means an agreement, whether oral or written, or contained in one or more documents, between a salesperson, whether or not he or she is a home improvement salesperson, and (a) an owner or (b) a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, which provides for the sale, installation, or furnishing of home improvement goods or services.

8. The Commission has also considered the option of basing the cap amount on the value of each claimant's portion of the home improvement contract, but this approach is more complicated to administer and would result in some subcontractors and suppliers being subject to the cap and others not subject to it in the same home improvement project. In addition, the homeowner would be protected from the smaller parts of the job, but not the larger claims.

9. See, e.g., 1969 Cal. Stat. ch. 1583 (enacting Bus. & Prof. Code §§ 7151.2, 7159). Special rules, including home improvement certification requirements are set out in Business and Professions Code Sections 7150-7168.

10. The historical development of the mechanic's lien law is summarized in "Appendix: Constitutional Considerations" *infra* pp. 9-30.

11. See Civ. Code § 3123. For a discussion of the constitutional issues concerning this type of proposal, see "Appendix: Constitutional Considerations" *infra* pp. 9-30.

$8,000 (depending on the assessment of the particular business). In most cases, an individual subcontractor or supplier's portion of a home improvement contract under [$25,000] would likely fall in the range of unforeclosable liabilities.

If a trade contractors or suppliers are reluctant to rely on the creditworthiness of their customers (the prime contractor or higher-tier subcontractor), they are free to work out an arrangement directly with the homeowner, either at the commencement of the project or later, upon the failure of the higher-tier contractor to pay for work or supplies already furnished.

The major defect in the existing system is reliance on the homeowner to sort through the various notices and correctly anticipate the best remedy. As a general rule, homeowners are likely to initiate few home improvement projects in a lifetime, whereas contractors and suppliers have daily experience in the business. This principle lies at the heart of consumer protection. Of course, there may also be significant inequalities in business and legal sophistication, bargaining power, financial soundness, and risk aversion among prime contractors, subcontractors, and suppliers. But as a class, those in the construction business and trades should be expected to have greater knowledge and sophistication about how things work than homeowners as a class.

PROPOSED LEGISLATION

Civ. Code § 3113. Limitation on owner's liability

SECTION 1. Section 3113 is added to the Civil Code, to read:

3113. (a) Notwithstanding any other provisions in this title, the liability of an owner under a home improvement contract executed in an amount less than twenty-five thousand dollars ($25,000) is limited to the amount remaining unpaid under the contract. Payments made to the original contractor in good faith discharge the owner's liability to all claimants to the extent of the payments.

(b) This section applies to home improvement contracts described in subdivision (a) regardless of any extras or change orders that increase the total amount of the contract.

(c) As used in this section, "home improvement contract" has the meaning provided by Section 7151.2 of the Business and Professions Code.

Comment. Section 3113 protects owners who, in good faith, pay the prime contractor according to the terms of a home improvement contract. This section is intended to shield owners from liability to pay twice for the same work, materials, or equipment in cases where subcontractors and suppliers do not receive payments that have been made by the owner. As made clear by the introductory clause of subdivision (a), this section provides an exception to the "direct lien" rule in Sections 3123 and 3124. Existing rights and procedures under this title remain applicable as to the amount remaining unpaid by the owner.

☞ **Staff Note.** As noted in Memorandum 2002-7, James Acret has proposed the following substitute language in subdivision (a): "The aggregate amount of all mechanics liens and stop notices that may be enforced against a home improvement project shall not exceed the amount earned by and remaining unpaid to the original contractor." The Commission needs to decide on the final phrasing of the provision so that the bill language can be put in proper form before it is introduced.

APPENDIX: CONSTITUTIONAL CONSIDERATIONS

A statutory revision that restricts or restructures the mechanic's lien right must be evaluated in light of the state constitutional provision mandating legislative implementation of mechanic's liens. Article XIV, Section 3, of the California Constitution provides as follows:

> Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and material furnished; and the Legislature shall provide, by law, for the speedy and efficient enforcement of such liens.[1]

Would a statute protecting homeowners from having to pay twice for the same labor or materials pass constitutional muster? Or is the proposed law within the acceptable range of legislative discretion in balancing competing interests? An understanding of the constitutional and statutory history and relevant case law is critical to answering these questions.

Background and History

The mechanic's lien statutes date back to the first Legislature, which enacted a rudimentary mechanic's lien statute on April 12, 1850 — five days before defining property rights of spouses.[2] The first mechanic's lien case reached the Supreme Court that same year, when the court ruled that a lumber merchant did not have a

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1. This is the language as revised in 1976, which is identical to the original 1879 provision in Article XX, Section 15, except that "persons furnishing materials" was substituted for the original "materialmen" by an amendment in 1974. Note that the beneficiaries of the constitutional lien differ from the statutory implementation in Civil Code Section 3110 (the constitutional classes are in bold):

> **Mechanics**, **materialmen**, contractors, subcontractors, lessors of equipment, **artisans**, architects, registered engineers, licensed land surveyors, machinists, builders, teamsters, and draymen, and all persons and **laborers of every class** performing labor upon or bestowing skill or other necessary services on, or furnishing materials or leasing equipment to be used or consumed in or furnishing appliances, teams, or power contributing to a work of improvement ….

Literally, only material suppliers and persons performing three classes of labor are covered by the constitutional language. An early treatise summarized the different classes of workers as follows: The man who constructs anything by mere routine and rule is a mechanic. The man whose work involves thought, skill, and constructive power is an artificer. The hod-carrier is a laborer; the bricklayer is a mechanic; the master mason is an artificer.…" Treatise on the Law of Mechanics' Liens and Building Contracts § 110, at 102 n.8 (S. Bloom ed. 1910). Currently, the statutes do not define "mechanic" or "artisan," but "laborer" is defined in Civil Code Section 3089(a) as "any person who, acting as an employee, performs labor upon or bestows skill or other necessary services on any work of improvement."

2. Compiled Laws ch. 155. Section 1 granted a lien to "master builders, mechanics, lumber merchants, and all other persons performing labor or furnishing materials" in constructing any building or wharf. Section 2 provided a notice procedure whereby any "sub-contractor, journeyman, or laborer" could, in effect, garnish payments from the owner. Section 3 provided for recording and commencement of an action "to enforce his lien."

lien on the building under the mechanic's lien statute where he had failed to comply with the 60-day recording period following completion of construction.[3]

The double liability problem appeared in the cases within the first decade. In *Knowles v. Joost*[4] the Supreme Court ruled that, under the statute, an owner who had paid the contractor in full was not liable to materialmen.[5]

In *McAlpin v. Duncan*[6] the court again addressed the double liability problem, this time under the 1858 statute:

> The question presented by the record is, whether the defendant, having paid the contractor in full before notice of the claims of these parties, can be compelled to pay a second time.…
>
> [The 1858 statute] is not a little confused and difficult of satisfactory construction. If it were designed to give to the sub-contractor and laborer a lien upon the property of the owner for the entire amount of the last or sub-contract, without any regard to the amount of the principal contract, a very curious anomaly would exist, and the whole property of the owner might be placed at the discretion of the contractor, to be encumbered by him as he chose. Such laws, as we have held in this very class of cases, are to be strictly construed, as derogating from the common law.…
>
> We think all that can be gathered from this act, is that material-men, sub-contractors, etc., have a lien upon the property described in the act to the extent (if so much is necessary) of the contract price of the principal contractor; that these persons must give notice of their claims to the owner, or the mere existence of such claims will not prevent the owner from paying the contractor, and thereby discharging himself from the debt; that by giving notice, the owner becomes liable to pay the sub-contractor, etc. (as on garnishment or assignment, etc.), *but that if the owner pays according to his contract, in ignorance of such claims, the payment is good*.
>
> Unless this view is correct, the grossest absurdities appear. We have, in the first place, a valid contract, with nothing appearing against it, which yet cannot be enforced — a clear right of action on the part of the contractor, with no defense by the defendant, and yet which cannot be enforced; *or* which the plaintiff may enforce at law, and yet, if the defendant pays the money, with or without suit, he must pay it again. Innumerable liens may be created, without the knowledge of the owner, for which he might be held liable; while the owner could never pay anything until after long delays, whatever the terms of the contract, or the contractor's necessity for money, unless payment were made at the expense, or at the risk of the payor. Such a construction would lead to law suits and difficulties innumer-

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3. Walker v. Hauss-Hijo, 1 Cal. 183 (1850).

4. 13 Cal. 620 (1859).

5. "It was not the design of the Legislature to make him responsible, except upon notice, or to a greater extent, than the sum due to the contractor at the date of the notice." *Id.* at 621. The first reported reference to the problem came in Cahoon v. Levy, 6 Cal. 295, 296-97 (1856):

> If they are to be allowed sixty days after the completion of the building to serve such notice on the owner, it will not unfrequently occur that he will be subjected to pay the same amount twice; as it will be impossible for him to ascertain the claims against the principal contractor, and his agreement with him may be for payment by instalments, or on the completion of the work.

6. 16 Cal. 126 (1860).

> able. By the other construction, no injustice is done or confusion wrought. These sub-contractors, etc., have only to notify their claims to the owner, in order to secure them. *If they, by their own laches, suffer the owner to pay over the money according to the terms of his contract, they ought not to complain; for it was by their own neglect of a very simple duty that the loss accrued; and it would be unjust to make the owner pay a second time because of that neglect.*[7]

Of course, cases such as *McAlpin* were decided before mechanic's liens were addressed in the constitution, but *McAlpin* touches on several themes that remain relevant 140 years later. The court was faced with a "confused" and "difficult" statute, and balanced the interests of the parties by placing responsibility where it logically lay, in order to avoid the injustice of double payment.

These cases were the beginning of a long line of consistent rulings, even though the statute changed in its details from time to time. Thus, in *Renton v. Conley*[8] the court ruled under the 1868 statute, as it had under the 1856 and 1858 statues, that

> notwithstanding the broad language of the statute, … where the owner had made payments to the contractor in good faith, under and in pursuance of the contract, before receiving notice, either actual or constructive, of the liens, the material men and laborers could not charge the buildings with liens, exceeding the balance of the contract price remaining unpaid when notice of the lien was given.

The first codification of the mechanic's lien statute in the 1872 Code of Civil Procedure included, in Section 1183, a provision that "the aggregate amount of such liens must not exceed the amount which the owner would otherwise liable to pay." But the code revisions of 1873-74 restored much of the language of the 1868 act, including the provision making contractors and subcontractors agents of the owner, and omitted the limitation on the aggregate amount of liens.

Nevertheless, the line of contract-based cases continued through the period of the Constitutional Convention in 1878-79 and thereafter, up until the "direct lien" revision in 1911 (with a brief detour through an 1880 amendment). This case law was reflected in the constitutional debates. In 1885 the statute was amended to reflect the basic contract analysis of the cases, with some creative rules applicable where the contract was void or not completed. The strict limitations imposed by the courts through the contract analysis resulted in hardship to subcontractors, suppliers, and laborers employed by the contractor where there were no payments were due because the contract was void or where the contractor abandoned the project. Under the cases during this era, only the amount remaining due and unpaid was available for claims of subcontractors, suppliers, and laborers not in privity with the owner.[9]

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7. *Id.* at 127-28 [emphasis added].

8. 49 Cal. 185, 188 (1874).

9. See, e.g., *Dingley v. Greene*, 54 Cal. 333, 336 (1880) ("if there is no existing lien on the original contract, none exists on the subsidiary contract"); *Wiggins v. Bridge*, 70 Cal. 437, 11 P. 754 (1886); F. James, The Law of Mechanics' Liens upon Real Property in the State of California §§ 80-81, at 83-85 (1900, Supp. 1902).

In 1885, however, the situation of the void contract was addressed, giving the claimants under the original contractor a direct lien for the value of their work, not limited by the contract amount.[10] Reflecting the perspective of 100 years ago, Counselor James in his treatise analyzed this rule as follows:

> The effect of section 1200 is, in all cases coming within its provisions, to charge the property of the owner with liens of persons other than the owner to the extent in value of the work actually done or of the materials actually furnished by them measured always by the standard of the contract price. If the effect was to *charge the property of the owner with such liens beyond the limit of the contract price, it would according to all of the authorities, be unconstitutional*.[11]

Clearly it was the expectation at the time, shortly after adoption of the constitutional mechanic's lien provision, that the mechanic's lien right was subject to overriding contract principles.

The 1885 amendments did not change the fundamental rule existing from the earliest years that protected a good-faith owner from liability for double payment where payments had already been made under the contract with the original contractor. Payment of any part of the contract price before commencement of the project was forbidden and at least 25% of the contract price was required to be withheld until at least 35 days after final completion. Code of Civil Procedure Section 1184 was revised to impose a duty on the owner to withhold "sufficient money" due the contractor to pay the claim of other lien claimants who gave notice to the owner. The amendments also required payment in money (later held unconstitutional), mandated written contracts for jobs over $1000, and provided for allowances for attorney's fees of claimants (later held unconstitutional).

End of the Contract Era

The dominance of the law of contract — which had survived repeated legislative adjustments in the 1850s through 1880, the Constitutional Convention of 1878-79, and the more significant legislative revisions in 1885 and after — came to an end with the revision of 1911.[12] Code of Civil Procedure Section 1183 was amended to adopt the "direct lien" approach: "The liens in this chapter provided for shall be direct liens, and shall not in the case of any claimants, other than the contractor be limited, as to amount, by any contract price agreed upon between the contractor and the owner except as hereinafter provided.…"[13] The pre-1911 limitation on the liability of the owner to amounts remaining due under the contract was now only available through obtaining a payment bond in the amount of 50% of the contract

10. See 1885 Cal. Stat. ch. 152, §§ 1, 2.

11. James, *supra* note 9, § 310, at 329.

12. 1911 Cal. Stat. ch. 681.

13. The rule in former Code of Civil Procedure Section 1183 is continued in Civil Code Section 3123, which also refers to "direct liens."

price. In general terms, the current statute is a direct descendent of the 1911 revisions.

The leading case of *Roystone Co. v. Darling*[14] gives a useful overview of the 1911 revision and the reasons for it, and places the statutory history in context with the case law. *Roystone* also is significant for the fact that it reflects a broad view of legislative power to implement the constitutional mandate:

> [The 1911 statutory] revision made some radical changes in the law, and it presents new questions for decision. It will aid in the understanding of the purpose and meaning of this act if we call to mind, as briefly as may be, the history of the mechanic's lien laws in this state and the state of the law on the subject at the time the amendments in question were enacted.
>
> Prior to the adoption of the constitution of 1879 the lien of mechanics and materialmen for work done and materials furnished in the erection of buildings was entirely a creature of the legislature. The former constitution contained no declaration on the subject. Numerous decisions of the supreme court had declared that all such liens were limited by the contract between the owner and the contractor, and could not, in the aggregate, exceed the contract price. The doctrine that the right of contract could not be invaded by legislative acts purporting to give liens beyond the price fixed in the contract between the owner and the contractor, or regardless of the fact that the price had been wholly or partially paid, was so thoroughly established that litigation involving it had virtually ended. Section 1183 of the [Code of Civil Procedure], as amended in 1874, declared that every person performing labor or furnishing materials to be used in the construction of any building should have a lien upon the same for such work or material. It did not limit the liens to the contract price. In this condition of the law the constitution of 1879 was adopted.…
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> ….
>
> In 1880 section 1183 was again amended by inserting a direct declaration that "the lien shall not be affected by the fact that no money is due, or to become due, on any contract made by the owner with any other party." This amendment of 1880 first came before the supreme court for consideration in *Latson v. Nelson*, [2 Cal. Unrep. 199], … a case not officially reported. The court in that case considered the power of the legislature to disregard the contract of the owner with the contractor and give the laborer or materialman a lien for an amount in excess of the money due thereon from the owner to the contractor. In effect, it declared that section 15, article XX, of the constitution was not intended to impair the right to contract respecting property guaranteed by section 1, article I, thereof, and that the provisions of the code purporting to give a lien upon property in favor of third persons, in disregard of and exceeding the obligations of the owner concerning that property, was an invalid restriction of the liberty of contract.… In the meantime the legislature of 1885 …, apparently recognizing and conceding the force of the decision in *Latson v. Nelson*, undertook to secure and enforce the constitutional lien by other means, that is, by regulating the mode of making and executing contracts, rather than by disregarding the right of contract. It amended sections 1183 and 1184 of the code by providing that in all building contracts the contract price should be payable in installments at specified times after the beginning of

14. 171 Cal. 526, 530-33, 37-38, 154 P. 15 (1915).

the work, that at least one-fourth thereof should be made payable not less than thirty-five days after the completion of the work contracted for, that all such contracts exceeding one thousand dollars should be in writing, subscribed by the parties thereto, and should be filed in the office of the county recorder before the work was begun thereunder, that if these regulations were followed, liens upon the property for the erection of the structure should be confined to the unpaid portion of the contract price, but that all contracts which did not conform thereto, or which were not filed as provided, should be void, that in such case the contractor should be deemed the agent of the owner, and the property should be subject to a lien in favor of any person performing labor or furnishing material to the contractor upon the building for the value of such labor or material. This law, with some amendments not material to our discussion, remained in force until the enactment of the revision of 1911 aforesaid.

In the meantime the supreme court has followed the rule established by the cases … and has uniformly declared, with respect to such liens, that if there is a valid contract, the contract price measures the limit of the amount of liens which can be acquired against the property by laborers and materialmen. [Citations omitted.] … In addition to these express declarations there are many cases in which the rights of the parties were adjudicated upon the assumption that this proposition constituted the law of the state. Each one of the large number of decisions regarding the priorities of liens in the unpaid portion of the contract price, each decision respecting the right to reach payments made before maturity under such contract, each decision as to the formal requisites of contracts under the amendment of 1885, and each decision as to the apportionment under section 1200 of the Code of Civil Procedure, upon the failure of the contractor to complete the work, constitutes an affirmance of the doctrine that the contract, legally made, limits the liability of the owner to lien claimants. There has been scarcely a session of this court since the enactment of that amendment at which one or more cases have not been presented and decided which, in effect, amounted to a repetition of this doctrine.…

….

We have shown that when [the 1911] act was passed it was the established doctrine of this state that the legislature cannot create mechanics' liens against real property in excess of the contract price, where there is a valid contract, but that it is within the legislative power, in order to protect and enforce the liens provided for in the constitution, and so far as for that purpose may be necessary, to make reasonable regulations of the mode of contracting, and even of the terms of such contracts, and to declare that contracts shall be void if they do not conform to such regulations.…

The portions of the act of 1911 … clearly show that the legislature did not intend thereby to depart from this doctrine, but that, on the contrary, the design was to follow it and to protect lienholders by means of regulations concerning the mode of contracting and dealing with property for the purposes of erecting improvements thereon. The first declaration on the subject is that the liens provided in the chapter shall be "direct liens" (whatever that may mean), and that persons, other than the contractor, shall not be limited by the contract price "except as hereinafter provided." The proviso referred to is found in the following declaration in the same section:

> "It is the intent and purpose of this section to limit the owner's liability, in all cases, to the measure of the contract price where he shall have filed or caused to be filed in good faith with his original contract a valid bond with good and sufficient sureties in the amount and upon the conditions as herein provided."
>
> A plainer declaration of the intention to make the contract price the limit of the owner's liability, where the bond and contract have been filed as required by this section, could scarcely be made.…

This lengthy quotation from *Roystone* provides a definitive exposition of the issues at a critical time when the contract era was giving way to the "direct lien" era following the 1911 amendments — in other words, a balancing of interests, formerly thought unconstitutional, that permits owners to be charged twice for the same work. There is not even a hint in this discussion that limiting liability to the amount of the contract could be unconstitutional.

Roystone did not overrule the earlier cases; the court upheld the new payment bond statute through the guise of declaring it to be consistent in intent with 60 years of case law. Experience since 1911 shows that the 50% payment bond has not served the purpose envisioned by the *Roystone* court of substituting for the protections in the old contract cases. This is particularly true in the home improvement context, where payment bonds are a rarity.

The court had occasion to reflect on the significance of *Roystone* with respect to limitations on legislative power in *Pacific Portland Cement Co. v. Hopkins*.[15] Responding to the appellant supplier's arguments, a three-judge department of the full court wrote:

> The final point made is that, since the Constitution gives a lien on property upon which labor is bestowed or materials furnished (Const. art. XX, sec. 15), the legislature has no power to enact a statute which shall limit the lien-claimant's recovery to the unpaid portion of the contract price. Whatever might be thought of this as an original question, it is no longer open or debatable in this court. In the recent case of *Roystone Co. v. Darling* … we reviewed the long line of decisions which had established in this state the soundness of the rule that "if there is a valid contract, the contract price measures the limit of the amount of liens which can be acquired against the property by laborers and materialmen." In the present case, the portion of the contract price applicable to the payment of liens was fixed in accordance with the rule laid down in section 1200 of the Code of Civil Procedure. That the specific method provided by this section is not in conflict with the Constitution was expressly decided in *Hoffman-Marks Co. v. Spires*, 154 Cal. 111, 115. The findings show that there was no unpaid portion of the contract price applicable to the payment of claimants who had furnished labor or materials to the original contractor. The conclusion of law that the defendant was entitled to judgment necessarily follows.

This review of the statutory, constitutional, and case law history from the earliest days until the dawning of the "direct lien" era demonstrates that limiting the

15. 174 Cal. 251, 255-56, 162 P. 1016 (1917).

owner's liability to the unpaid contract price was not only constitutional, but recognized as the expected standard against which variations had to be judged. The constitutional shoe was on the other foot in this era, with the burden of proving constitutionality on those who would limit or condition this well-understood principle.

Scope of Legislative Authority

The Legislature has significant discretion in meeting its constitutional duties. In fashioning its implementation of the constitutional direction to "provide, by law, for the speedy and efficient enforcement" of mechanic's liens, the Legislature is required to balance the interests of affected parties.

The constitutional language "shall have a lien" might appear to directly create a mechanic's lien, and courts have occasionally dealt with the argument that there is a "constitutional lien," somehow distinct from the statutory implementation. In an early case, the court described it as follows:[16]

> This declaration of a right, like many others in our constitution, is inoperative except as supplemented by legislative action.
>
> So far as substantial benefits are concerned, the naked right, without the interposition of the legislature, is like the earth before the creation, "without form and void," or to put it in the usual form, the constitution in this respect is not self-executing.

Cases have distinguished between the constitutional right to the lien and the statutory lien itself.[17] The constitutional provision is "not self-executing and is inoperative except to the extent the Legislature has provided by statute for the exercise of the right."[18] The court in the leading case of *Frank Curran Lumber Co. v. Eleven Co.*[19] explained that the constitution is

> inoperative except as supplemented by the Legislature through its power reasonably to regulate and to provide for the exercise of the right, the manner of its exercise, the time when it attached, and the time within which and the persons against whom it could be enforced. *The constitutional mandate is a two-way street, requiring a balancing of the interests of both lien claimants and property owners.* In carrying out this constitutional mandate the Legislature has the duty of balancing the interests of lien claimants and property owners.[20]

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16. Spinney v. Griffith, 98 Cal. 149, 151-52, 32 P. 974 (1893).

17. See, e.g., Solit v. Tokai Bank, Ltd., 68 Cal. App. 4th 1435, 1445-47, 81 Cal. Rptr. 2d 243 (1999); Koudmani v. Ogle Enter., Inc., 47 Cal. App. 4th 1650, 1655-56, 55 Cal. Rptr. 2d 330 (1996).

18. Wilson's Heating & Air Conditioning v. Wells Fargo Bank, 202 Cal. App. 3d 1326, 1329, 249 Cal. Rptr. 553 (1988); Morris v. Wilson, 97 Cal. 644, 646, 32 P. 801 (1893).

19. 271 Cal. App. 2d 175, 183, 76 Cal. Rptr. 753 (1969).

20. 271 Cal. App. 2d at 183 (emphasis added).

It is this balancing of interests that the Commission has sought in preparing its recommendation, and that the Legislature must do whenever significant amendments are made affecting right to a mechanic's lien.

Purpose and Justification of Lien

The mechanic's lien was unknown at common law. The early cases adopted the traditional strict construction approach to the statute.[21] The lien is usually justified on the ground that the lien claimant has increased the value of the owner's property through labor, services, or materials supplied, and it would unjustly enrich the owner if the benefits could be enjoyed without payment.[22] Thus, it is fitting that the laborer and supplier should follow the fruits of their activities into the building (and some land) that has been enhanced.

Traditionally the measure of the lien has been tied to a contract price or the value of the claimant's contribution, however, not a specific measure of the increase in the value brought about by the claimant's enhancements through labor and supplies. Where the owner has paid the amounts owing under the contract, the unjust enrichment argument fades away and provides no support for requiring the owner to pay subcontractors and suppliers who did not receive payments from the contractor with whom they did business.

Original Intent of Constitutional Provision

There is strong evidence that the constitutional language was not meant to permit imposition of double liability on property owners. The language of the mechanic's lien provision placed in Article XX, Section 15, was discussed in some detail, as recorded in the Debates and Proceedings of the California Constitutional Convention of 1878-79.[23] The Convention soundly rejected proposed language to make clear that "no payment by the owner … shall work a discharge of a lien." This rejection took place with the certain knowledge that the Supreme Court had consistently held that liens were limited to the contract price under the statutes in force at the time.

In reviewing the constitutional history, one analyst has concluded:

> [T]he delegates clearly left the decision regarding the enforcement of liens for the Legislature to determine by statute. In rejecting the amendment, the delegates preserved the right of [the] Legislature to enact reasonable regulations limiting mechanic's liens, including statutes that grant homeowners a defense based on full payment. When viewed within the context of the Debates and Proceedings,

21. See, e.g., Bottomly v. Grace Church, 2 Cal. 90, 91 (1852).

22. See, e.g., Avery v. Clark, 87 Cal. 619, 628, 25 P. 919 (1891).

23. For further discussion and excerpts from the Debates and Proceedings relevant to mechanic's liens, see Second Supplement to Commission Staff Memorandum 2000-9 (Feb. 11, 2000), Exhibit pp. 9-11, 20-24.

the very system that is now in place was in fact rejected by the delegates of the Constitution Convention.[24]

This constitutional history has been usefully summarized in a law review comment as follows:

> The delegates participating in the debate were obviously aware of the fact that an earlier decision had construed mechanics' liens as limited to the amount found due and owing to the contractor. The drafting committee reported out the provision in the form in which it was ultimately enacted.
>
> A Mr. Barbour introduced an amended version which would have made the liens unlimited and would also have made the owner personally liable for them. There was some talk of revising the offered amendment to eliminate the feature of personal liability while retaining unlimited lien liability. Such a revision was never made, so the delegates never had the opportunity to vote on the simple issue of limited versus unlimited liens. The proponents of the Barbour amendment indicated that their primary interest was in aiding the laborer; materialmen were included as potential lienors without any real reason for including them advanced. No one contended that it was proper that an innocent homeowner should be subjected to "double payment." Instead, the proponents of the amendment assumed that the honest owner would be fully aware of the law and be able to protect himself. The principal argument in support of the Barbour amendment was that it would prevent "collusion" between "thieving contractors and scoundrelly owners who connive to swindle the workman out of his wages." … The opponents of the amendment used some rather strong language in asserting their position. One called the amendment a "fraud" and "infirm in principle." At all events, the amendment was voted down. Since most of the speakers seemed to be of the opinion that unlimited liens would not be permitted under the constitution unless expressly authorized therein, the fact that the Barbour amendment was defeated would seem to indicate an intention on the part of the delegates that unlimited liens should not be allowed. This cannot be stated with certainty, however, since one of the delegates was of the opinion that the provision as ultimately enacted would leave the question of limited or unlimited liens up to the legislature. Thus, there remains the possibility that the delegates adopted his view, and decided to dump the question into the legislators' laps. It can be stated categorically that, since no one thought that innocent homeowners should be subjected to "double payment," the delegates did not give their stamp of approval in advance to the present scheme of mechanics' liens.[25]

A contrary interpretation of the debates is possible, since the Legislature in 1880 amended Code of Civil Procedure Section 1183 to provide that the lien "shall not be affected by the fact that no money is due, or to become due, on any contract

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24. Keith Honda, Mechanics Lien Law Comments [Draft], p. 7 (Feb. 10, 2000) (attached to Second Supplement to Commission Staff Memorandum 2000-9 (Feb. 11, 2000), Exhibit p. 11).

25. Comment, *The "Forgotten Man" of Mechanics' Lien Laws — The Homeowner*, 16 Hastings L.J. 198, 216-18 (1964) [footnotes omitted]. Research has not revealed a single case, among nearly 900 mechanic's lien cases reported since 1879, that refers to the constitutional *Debates and Proceedings*. Fewer than 10 cases have discussed the "double payment" problem, and none of them reviewed the original intent of the framers of the constitutional mechanic's lien right.

made by the owner with any other party."[26] It is possible to conclude from the transcript that the debate resulted in a stand-off, with the extent of the lien left to later legislative determination. But even this interpretation of the original intent does not provide support for the position that the Legislature is powerless to limit, condition, or redirect certain mechanic's lien rights as a result of balancing competing interests. Both interpretations of the constitutional debates support the Legislature's power to limit liens for important policy reasons.

Limits on Legislative Power

Some authorities argue that restricting or eliminating the mechanic's lien right where the owner has paid the contractor in full would be unconstitutional.[27] Other authorities disagree.[28]

Since the particular question of limiting the homeowner's liability to amounts remaining unpaid under the contract has not been decided in modern times, those who believe this approach would be unconstitutional rely on quotations from the cases concerning the special status of the mechanic's lien. Great reliance is placed on two California Supreme Court cases decided in the last 25 years: *Connolly Development, Inc. v. Superior Court*[29] and *Wm. R. Clarke Corp. v. Safeco Insurance Co.*[30]

Connolly was a 4-3 decision upholding the constitutionality of the mechanic's lien statute against a challenge based on the claim that the imposition of the lien constituted a taking without due process. Strikingly, however, *Connolly* is not relevant to the question of whether a good-faith payment exception to double liability for mechanic's lien claims would be constitutional — the constitutionality of the mechanic's lien statute itself was the issue in the case. In upholding the statute, *Connolly* employed a balancing of interests in determining whether the taking without notice could withstand constitutional scrutiny. For the purposes of the Commission's proposal, *Connolly* is of interest because it illustrates that balancing of creditors' and debtors' rights must occur in considering mechanic's lien issues. This case is not relevant to the issue of whether the Legislature can constitutionally balance the interests of homeowners and mechanic's lien claimants through a rule protecting the owner from double payment liability.

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26. 1880 Cal. Code Amends. ch. 67, § 1.

27. See, e.g., Hunt, *Report to Law Revision Commission Regarding Recommendations for Changes to the Mechanic's Lien Law* [Part 2] (February 2000) (attached to Commission Staff Memorandum 2000-9 (Jan. 31, 2000)); see also First Supplement to Commission Staff Memorandum 2000-26 (April 10, 2000); Abdulaziz memorandum (attached to First Supplement to Commission Staff Memorandum 2000-36 (June 15, 2000)).

28. See, e.g., Honda, *supra* note 24; Acret letter (Aug. 25, 1999) (quoted in Honda, *id.* at 2-5).

29. 17 Cal. 3d 803, 553 P.2d 637, 132 Cal. Rptr. 477 (1976) (upholding mechanic's lien statute against due process attack).

30. 15 Cal. 4th 882, 938 P.2d 372, 64 Cal. Rptr. 2d 578 (1997) (pay-if-paid contract provision void as against public policy).

In *Wm. R. Clarke Corp. v. Safeco* a divided court struck down pay-if-paid clauses in contracts between contractors and subcontractors. *Clarke* involved *contractual* waivers of an important constitutional right which were found to be *against* legislated public policy. The analysis undertaken in *Clarke* is clearly distinct from that required to determine whether a new public policy established by statute, in which the Legislature has balanced the competing interests, can properly be balanced against the lien right. In *Clarke* the owner had not paid and the surety company was trying to avoid paying. These equities differ markedly from the situation addressed in the Commission's proposal, concerning cases where the owner has already paid in good faith.

Most relevant to an understanding of the extent of the Legislature's power to shape the implementing statute and to condition and limit the broad constitutional language are the following:

Roystone, quoted at length earlier, is probably the most significant decision because it held the 1911 payment bond reform valid and attempted to harmonize the new reforms with the contract rule that had prevailed for 60 years. Justice Henshaw's lone concurring opinion in *Roystone*[31] — to the effect that it is "wholly beyond the power of the Legislature to destroy or even to impair this lien" — was an extreme minority opinion even then.

Martin v. Becker[32] contains some strong language about the sanctity of the mechanic's lien: "[T]he lien of the mechanic in this state … is a lien of the highest possible dignity, since it is secured not by legislative enactment but by the constitution.… Grave reasons indeed must be shown in every case to justify a holding that such a lien is lost or destroyed." This language is directed toward the exercise of judicial authority in a case where the court was called upon to determine whether the right to a mechanic's lien was lost when the claimant had also obtained security by way of a mortgage. Although the court's sentiments may be

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31. 171 Cal. at 544. Justice Henshaw appears to have believed that even the 50% bonding provision was suspect:

> The owner may have paid the contractor (and he is not prohibited from so doing) everything that is due, and in such case this language would limit the right of the recovery of the lien claimant to what he could obtain under the bond. In short, he would have no lien upon the property at all. Here is as radical a denial of the constitutional lien as is found in any of the earlier statutes. The inconsistency between this language and other parts of the act is too apparent to require comment. Yet, as this seems to have been the deliberate design of the legislature, it is perhaps incumbent upon this court under its former decisions to give that design legal effect. If the legislature in fact means to give claimants the rights which the constitution guarantees them, as it declares its desire to do in section 14 [of 1911 Cal. Stat. ch. 681] …, it alone has the power to do so by language which will make it apparent that a lien claimant may still have recourse to the property upon which he has bestowed his labor if the interposed intermediate undertaking or fund shall not be sufficient to pay him in full. This court is, however, justified, I think, in waiting for a plainer exposition of the legislature's views and intent in the matter than can be found in this confused and confusing statute.

Id. at 546. Missing from this concurring opinion is any notion of balancing the rights of the owner.

32. 169 Cal. 301, 316, 146 P. 665 (1915).

sound, they are irrelevant to the standards for reviewing a legislative determination of the proper balance between competing interests.

Judicial recognition that the state has a "strong policy" favoring laws giving laborers and materialmen security for their liens[33] addresses only one element in the Legislative balancing process and does not determine the outcome where the Legislature determines that homeowners need protection from having to pay twice for the same home improvements through no fault of their own.

In *English v. Olympic Auditorium, Inc.*,[34] the court wrote: "Should the lien laws be so interpreted as to destroy the liens because the leasehold interest has ceased to exist, such interpretation would render such laws unconstitutional." But in this case there was no double payment — there was not even a single payment. The court ruled that mechanic's liens remained on a structure built by the lessee whose lease had terminated, notwithstanding the lease provision making any construction a fixture inuring ultimately to the lessor's benefit.

Young v. Shriver[35] has been cited for the language "we presume that no one will say that the right to the remedy expressly authorized by the organic law can be frittered away by any legislative action or enactment." But this is a case where the court rejected a mechanic's lien claim for the labor of plowing agricultural land, taking into account the technicalities of distinguishing between the first plowing and later plowings. The court did not find plowing at any time to be an "improvement" within the constitutional or statutory language.

Hammond Lumber Co. v. Barth Investment Corp.[36] repeats the *Martin v. Becker* language in a case concerning a technical question of whether a building had actually been completed for purposes of a 90-day lien-filing period. The court wrote: "The function of the legislature is to provide a system through which the rights of mechanics and materialmen may be carried into effect, and this right cannot be destroyed or defeated either by the legislature or courts, unless grave reasons be shown therefor." This case did not involve an issue of the scope of the Legislature's power to "destroy or defeat" the lien upon a showing of grave reasons.

Hammond Lumber Co. v. Moore[37] resolved the issue whether the Land Title Law, enacted by initiative, violated the mechanic's lien provision in the constitution. The court found that the lien recording requirement was not unduly burdensome, and in dicta speculated that "the second sentence of section 93, by denying the creation of a lien unless the notice is filed, violates the forepart of article XX, section 15, of the Constitution, granting a lien." But that issue was not before the court, and similar procedural requirements have been accepted in the mechanic's lien law for years without challenge.

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33. E.g., *Connolly*, 17 Cal. 3d at 827.
34. 217 Cal. 631, 640, 20 P.2d 946 (1933).
35. 56 Cal. App. 653, 655, 206 P. 99 (1922).
36. 202 Cal. 606, 610, 262 P. 31 (1927).
37. 104 Cal. App. 528, 535, 286 P. 504 (1930).

The source of some interesting language cited in a number of later cases is *Diamond Match Co. v. Sanitary Fruit Co.*:[38]

> The right of mechanics, materialmen, etc., to a lien upon property upon which they have bestowed labor, or in the improvement of which material which they have furnished have been used, for the value of such labor or materials, is guaranteed by the Constitution, the mode and manner of the enforcement of such right being committed to the Legislature.… Manifestly, the legislature is not thus vested with arbitrary power or discretion in attending to this business. Indeed, rather than power so vested in the legislature, it is a command addressed by the constitution to the law-making body to establish a reasonably framed system for enforcing the right which the organic law vouchsafes to the classes named. Clearly, it is not within the right or province of the legislature, by a cumbersome or ultratechnical scheme designed for the enforcement of the right of lien, to impair that right or unduly hamper its exercise. Every provision of the law which the Legislature may enact for the enforcement of the liens … must be subordinate to and in consonance with that constitutional provision.…
>
> But, while all that has been said above is true, it will not be denied that it is no less the duty of the legislature, in adopting means for the enforcement of the liens referred to in the constitutional provision, to consider and protect the rights of owners of property which may be affected by such liens than it is to consider and protect the rights of those claiming the benefit of the lien laws. The liens which are filed under the lien law against property, as a general rule, grow out of contracts which are made by and between lien claimants and persons (contractors) other than the owner of the property so affected, and such liens may be filed and so become a charge against property without the owner having actual knowledge thereof. The act of filing, as the law requires, constitutes constructive notice to the owners and others that the property stands embarrassed with a charge which will operate as a cloud upon the title thereof so long as the lien remains undischarged and that the property may be sold under foreclosure proceedings unless the debt to secure which the lien was filed is otherwise sooner satisfied. The filing of the claim in the recorder's office is intended to protect the owner of the property against double payment to the contractor or payment for his services and the materials he uses in the work of improvement in excess of what his contract calls for. The notice is also intended for the protection of those who may as to such property deal with the owner thereof — that is, third persons as purchasers or mortgagees.

In this case, the court held the claimant to the statutory requirement that the owner's name be stated correctly on the lien claim, since otherwise no one examining the record index would know that the claim had been filed as to the owner's property.

There is also a presumption in favor of the validity of statutes which may be applied to uphold legislative balancing of different interests in the mechanic's lien

38. 70 Cal. App. 695, 701-02, 234 P. 322 (1925).

context. Legislative discretion was discussed in *Alta Building Material Co. v. Cameron* as follows:[39]

> The following language in *Sacramento Municipal Utility Dist. v. Pacific Gas & Elec. Co*., 20 Cal. 2d 684, 693, [128 P.2d 529] is applicable: "The contention that the section in question [Code Civ. Proc. § 526b] lacks uniformity, grants special privileges and denies equal protection of the laws, is also without merit. None of those constitutional principles is violated if the classification of persons or things affected by the legislation is not arbitrary and is based upon some difference in the classes having a substantial relation to the purpose for which the legislation was designed. [Citations.] … Wide discretion is vested in the Legislature in making the classification and every presumption is in favor of the validity of the statute; the decision of the Legislature as to what is a sufficient distinction to warrant the classification will not be overthrown by the courts unless it is palpably arbitrary and beyond rational doubt erroneous. [Citations.] A distinction in legislation is not arbitrary if any set of facts reasonably can be conceived that would sustain it." [Citations omitted.]
>
> While the essential purpose of the mechanics' lien statutes is to protect those who have performed labor or furnished material towards the improvement of the property of another (*Nolte v. Smith*, 189 Cal. App. 2d 140, 144 [11 Cal. Rptr. 261], inherent in this concept is a recognition also of the rights of the owner of the benefited property. It has been stated that the lien laws are for the protection of property owners as well as lien claimants (*Shafer v. Los Serranos Co.*, 128 Cal. App. 357, 362 [17 P.2d 1036]) and that our laws relating to mechanics' liens result from the desire of the Legislature to adjust the respective rights of lien claimants with those of the owners of property improved by their labor and material. (*Corbett v. Chambers*, 109 Cal. 178, 181 [41 P. 873].) … [Quotation from *Diamond Match Co.* omitted.]
>
> Viewing section 1193 within the framework of these principles, we are unable to state that the Legislature acted arbitrarily and unreasonably in making the classification which it did.
>
> The section does not require a pre-lien notice by those under direct contract with the owner or those who perform actual labor for wages on the property. The logical reason for this distinction is that the owner would in the usual situation be apprised of potential claims by way of lien in connection with those with whom he contracts directly, as well as those who perform actual labor for wages upon the property.
>
> However, as to materials furnished or labor *supplied* by persons not under direct contract with the owner, it may be difficult, if not impossible, for the owner to be so apprised and the clear purpose of section 1193 is to give the owner 15 days' notice in such a situation that his property is to be "embarrassed with a charge which will operate as a cloud upon the title thereof so long as the lien remains undischarged, and that the property may be sold under foreclosure proceedings unless the debt to secure which the lien was filed is otherwise sooner satisfied." (*Diamond Match Co. v. Sanitary Fruit Co., supra*, p. 702.)

39. 202 Cal. App. 2d 299, 303-04, 20 Cal. Rptr. 713 (1962).

The court in *Alta Building Material* distinguished the Supreme Court case of *Miltimore v. Nofziger Bros. Lumber Co.*,[40] a 4-3 decision holding unconstitutional a statutory rule giving priority to laborers over material suppliers in satisfaction of mechanic's lien claims against the proceeds from the sale of the liened property.[41] Although *Miltimore* is short on detail, the *Alta Building Material* court concluded that *Miltimore* involved classifications "as to substantive matters," whereas Section 1193 at issue in *Alta Building Material* involved a procedural matter — "the right itself is not denied or impaired."

Balancing Interests

There have been a number of schemes implementing the constitutional direction since 1879, and several statutory provisions have been challenged for being unconstitutional as measured against the language of the constitution. Throughout the years, the courts have rejected most constitutional challenges to aspects of the statutes, recognized a number of exceptions to the scope of the constitutional provision, and generally have deferred to the Legislature's balancing of the interests. Of course, the Legislature can't ignore the constitutional language, but the case law does not yet indicate the limit of statutory balancing of the respective interests.

In early cases, the fundamental property rights of the owner received frequent judicial attention. For example, in the course of striking down the statute requiring payment of construction contracts in money, the court in *Stimson Mill Co. v. Braun*[42] explained:

> The provision in the constitution respecting mechanics' liens (art. XX 20, sec. 15) is subordinate to the Declaration of Rights in the same instrument, which declares (art. I, sec. 1) that all men have the inalienable right of "acquiring, possessing and protecting property," and (in sec. 13) that no person shall be deprived of property "without due process of law." The right of property antedates all constitutions, and the individual's protection in the enjoyment of this right is one of the chief objects of society.

In considering whether it was constitutionally permissible to make procedural distinctions between different classes of lien claimants, the Supreme Court explained in *Borchers Bros., v. Buckeye Incubator Co.*:[43]

> The problem is therefore presented whether the Legislature's procedural distinction in section 1193 of the Code of Civil Procedure, requiring notice by a materialman but not by a laborer, is so arbitrary and unreasonable that there is no substantial relation to a legitimate legislative objective.

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40. 150 Cal. 790, 90 P. 114 (1907).

41. Subcontractors and original contractors were ranked third and fourth under Code of Civil Procedure Section 1194, as amended by 1885 Cal. Stat. ch. 152, § 4.

42. 136 Cal. 122, 125, 68 P. 481 (1902).

43. 59 Cal. 2d 234, 238-39, 379 P.2d 1, 28 Cal. Rptr. 697 (1963).

> The constitutional mandate of article XX, section 15, is a two-way street, requiring a balancing of the interests of both lien claimants and property owners. First, this argument could appropriately be presented to the Legislature and not to the courts. Second, in carrying out this constitutional mandate, the Legislature has the duty of balancing the interests of lien claimants and property owners.

Examples of "Balanced Interests"

Situations where the Legislature has balanced competing interests are evident in the cases discussed above. Other mechanic's lien balancing acts include: the limitation of lien rights to licensed contractors; the statutory notice of nonresponsibility that frees an owner from liability for tenant improvements, even though they benefit the owner; the priority of future advances under a prior deed of trust; the exemption for public works.

With respect to this history of balancing interests, one expert has concluded:

> In each of these cases, the legislature has made a policy decision that the constitutional right to a mechanics lien should yield to legitimate interests of property owners.
>
> In one case, the legislature decided that a property owner should be protected against liens for work ordered by a tenant even though construction ordered by a tenant is just as valuable as any other construction. In another case, the legislature decided that it was more important to encourage construction financing by institutional lenders than to protect mechanics lien rights. In the last case, the legislature simply decided that public agencies should be exempt from mechanics lien claims.[44]

Licensed Contractor Limitation

Since 1931, unlicensed contractors have been precluded from recovering compensation "in any action in any court of this state for the collection of compensation" for activities required to be licensed.[45] In *Alvarado v. Davis*,[46] the court denied enforcement of a mechanic's lien by an unlicensed contractor based on the licensing requirement enacted in 1929, even before the statute provided an explicit bar.[47]

The current rule is set out in Business and Professions Code Section 7031. The courts have affirmed the intent of the Legislature "to enforce honest and efficient construction standards" for the protection of the public.[48] The severe penalty in the nature of a forfeiture caused some unease when courts were faced with technical violations of the licensing statute, giving rise to the substantial compliance doc-

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44. Acret Letter, *supra* note 28.
45. See 1931 Cal. Stat. ch. 578, § 12.
46. 115 Cal. App. Supp. 782, 783 (1931).
47. See 1929 Cal. Stat. ch. 791, § 1.
48. See Famous Builders, Inc. v. Bolin, 264 Cal. App. 2d 37, 40-41, 70 Cal. Rptr. 17 (1968).

trine.[49] The Legislature acted to rein in the substantial compliance doctrine by amendments starting in 1991 restricting the doctrine to cases where the contractor has been licensed in California and has acted reasonably and in good faith to maintain licensure, but did not know or reasonably should not have known of the lapse.[50]

In *Vallejo Development Co. v. Beck Development Co.*,[51] the court reaffirmed the authority of the licensing rules:

> California's strict contractor licensing law reflects a strong public policy in favor of protecting the public against unscrupulous and/or incompetent contracting work. As the California Supreme Court recently reaffirmed, "The purpose of the licensing law is to protect the public from incompetence and dishonesty in those who provide building and construction services.… The licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business."

The constitutional mechanic's lien provision predates the licensing regime by 50 years. The decisions do not question the propriety of this major limitation on the constitutional lien. Even though a disfavored forfeiture can result from application of the licensing rules, the mechanic's lien right bows before the policy of protecting the public implemented in the licensing statute.[52]

Public Works

The statutes make clear that the mechanic's lien is not available in public works.[53] A "public work" is defined as "any work of improvement contracted for by a public entity."[54] The constitutional mechanic's lien provision does not contain this limitation.

The statutory rule appears first in 1969.[55] However, by 1891 the California Supreme Court had ruled that the constitutional mechanic's lien provision could not apply to public property as a matter of public policy. In *Mayrhofer v. Board of*

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49. See, e.g., Latipac, Inc. v. Superior Court, 64 Cal. 2d 278, 279-80, 411 P.2d 564, 49 Cal. Rptr. 676 (1966).

50. Bus. & Prof. Code § 7031(d)-(e); see also Bus. & Prof. Code § 143 (general bar to recovery by unlicensed individuals and prohibition on application of substantial compliance doctrine).

51. 24 Cal. App. 4th 929, 938, 29 Cal. Rptr. 2d 669 (1994).

52. The scope of the licensing rules is limited. The bar only applies to those who are required to be licensed for the activity they are conducting. Thus, for example, a person who is hired as an employee to supervise laborers in constructing a house is not a contractor. See, e.g., Frugoli v. Conway, 95 Cal. App. 2d 518, 213 P.2d 76 (1950). Although there is no case deciding the issue, it is assumed that unlicensed contractors who are not required to be licensed because they only contract for jobs under $500 (see Bus. & Prof. Code § 7048) are still entitled to the mechanic's lien law remedies because the bar of Business and Professions Code Section 7031 would not apply to them.

53. Civ. Code § 3109.

54. Civ. Code § 3100; see also §§ 3099 ("public entity" defined), 3106 ("work of improvement" defined).

55. 1969 Cal. Stat. ch. 1362, § 2 (enacting Civ. Code § 3109).

Education,[56] a supplier sought to foreclose a lien for materials furnished to a subcontractor for building a public schoolhouse. Although the constitutional provision is unlimited in its use of "property" to which the lien attaches for labor or materials furnished, the court found that "the state is not bound by general words in a statute, which would operate to trench upon its sovereign rights, injuriously affects its capacity to perform its functions, or establish a right of action against it." [57] The court termed it "misleading to say that this construction is adopted on the ground of public policy," thus distinguishing this limitation on the scope of the mechanic's lien from other balancing tests. Rather, the interpretation follows from the original intent of the language to provide remedies for private individuals; it would be an "unnatural inference" to conclude otherwise.[58] Constitutional provisions for the payment of state debts through taxation and restrictions on suits against the state bolster the conclusion that general provisions like the mechanic's lien statute and its implementing legislation do not apply to the state and its subdivisions.[59]

Special Protections of Homeowner and Consumer Interests

Modern California law provides a number of special protections for homeowners.[60] This special treatment evidences legislative concern for this fundamental class of property and suggests the propriety of balancing that interest with the mechanic's lien right. This is not entirely a modern development. Just as the mechanic's lien is the only creditor's remedy with constitutional status, the homestead exemption is also constitutionally protected.[61]

The California codes are replete with consumer protection statutes that condition the freedom of contract and other fundamental rights. Particularly relevant here is the Contractors' State License Law,[62] which contains numerous provisions limiting activities of contractors in the interest of consumer protection.

Other Constitutional Rulings

A few cases have held different aspects of the mechanic's lien statute unconstitutional and are noted below. These cases do not shed much light on the constitutionality of modern reform proposals addressing the double liability problem. In fact, as the older cases tended to favor contract rights over the rights of mechanic's

56. 89 Cal. 110, 26 P. 646 (1891).

57. *Id.* at 112.

58. *Id.* at 113.

59. *Accord* Miles v. Ryan, 172 Cal. 205, 207, 157 P. 5 (1916).

60. See, e.g., Bus. & Prof. Code § 10242.6 (prepayment penalties); Civ. Code §§ 2924f (regulation of powers of sale), 2949 (limitation on due-on-encumbrance clause), 2954 (impound accounts), 2954.4 (late payment charges).

61. See Cal. Const. art. XX, § 1.5 ("The Legislature shall protect, by law, from forced sale a certain portion of the homestead and other property of all heads of families.")

62. Bus. & Prof. Code §§ 7000-7191

lien creditors, they lend support to the Commission's proposal to protect good-faith payments under the homeowner's contract with the prime contractor.

Gibbs v. Tally[63] invalidated the mandatory bond provision in Code of Civil Procedure Section 1203, as enacted in 1893, as an unreasonable restraint on the owner's property rights and an unreasonable and unnecessary restriction on the power to make contracts.

Stimson Mill Co. v. Braun[64] held the requirement of payment in cash in the 1885 version of Code of Civil Procedure Section 1184 was unconstitutional as an interference with property and contract rights.

The allowance of attorney's fees as an incident to lien foreclosure under the 1885 version of Code of Civil Procedure 1195 was invalidated in *Builders' Supply Depot v. O'Connor*.[65]

The most relevant case is *Parsons Brinckerhoff Quade & Douglas, Inc. v. Kern County Employees Retirement Ass'n*,[66] cited in a recent Legislative Counsel's opinion.[67] Assembly Member Mike Honda requested an opinion from the Legislative Counsel on the following question:

> Would a statute be unconstitutional if it provides the owner of residential real property who pays a contractor in full for a work of improvement on the property with a defense against a mechanics' lien filed by a subcontractor who has bestowed labor on, or furnished material for, that work of improvement?

The Opinion concluded that such a statute would be unconstitutional. While it cites a broad statement in the case law concerning the legislative power in relation to the constitution,[68] the Opinion does not mention the limitations on the constitutional provision resulting from balancing competing policies, such as the contractor licensing rules, nor does it consider the constitutional history as reflected in the *Debates and Proceedings*. The Opinion does not mention the early case law, nor the statutes from 1885 to 1911, under which good-faith payment to the prime contractor without notice of other claims acted as a shield against mechanic's liens.

Although the Opinion recognizes that the Legislature has "plenary power to reasonably regulate and provide for the exercise of this right, the manner of its exercise, the time when it attached, and the time within which and the persons against whom it could be enforced" it concludes:

> However, on the other hand, we think that a statute that provides the owner of residential real property with a defense against a mechanics' lien by a subcontrac-

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63. 133 Cal. 373, 376-77, 65 P. 970 (1901) (distinguished in *Roystone*).

64. 136 Cal. 122, 125, 68 P. 481 (1902).

65. 150 Cal. 265, 88 P. 982 (1907).

66. 5 Cal. App. 4th 1264, 7 Cal. Rptr. 2d 456 (1992).

67. See Legis. Counsel Opinion #13279, May 11, 1999 (attached to Second Supplement to Commission Staff Memorandum 2000-9 (Feb. 11, 2000), Exhibit pp. 25-30) [hereinafter "Opinion"].

68. *Diamond Match Co.*, *supra* note 38.

> tor whenever the owner pays a contractor in full would effectively deny the subcontractor the right to enjoy the benefits of the lien because a payment in full to the contractor does not necessarily protect the subcontractor's right to be paid.

The Commission does not believe this conclusion follows from the analysis.

The Opinion does not consider the requirement of legislative balancing between the interests of potential lien claimants and owners, as recognized in the lengthy text it quotes from the *Borchers* case. The Opinion does not analyze the interests involved in implementing the constitutional duty. The Opinion recognizes that failure to follow parts of the existing statutory procedure result in the loss of the lien right, but fails to consider how the defense of full payment might be implemented through similar notices, opportunities to object, demands, good-faith determinations and the like.

As the lengthy history of mechanic's liens in California prior to 1911 clearly shows, such a scheme can be and has been constitutionally implemented.

Probably the most meaningful point in the Opinion is the citation to *Parsons Brinckerhoff Quade & Douglas, Inc. v. Kern County Employees Retirement Ass'n*.[69] The Opinion cites this case for the proposition that "the Legislature, in carrying out its constitutional mandate … may not effectively deny a member of a protected class the benefits of an otherwise valid lien by forbidding its enforcement against the property of a preferred person or entity." But *Parsons* involved the conflict between a special debtor's exemption statute and the mechanic's lien law. To uphold the exemption would mean that the fund would receive a windfall. This is not the situation where the homeowner has paid in full under the contract with the prime contractor. The proposal does not impose a categorical exemption of homeowners from liability under home improvement contracts. In the absence of such a proposal, *Parsons* is not on point.

Conclusion on Constitutionality of Reforms

The Commission's review of the constitutional issues leads to the conclusion that the proposal to protect good-faith payments by owners under home improvement contracts would be constitutional. This follows from a review of the constitutional intent, case law history, statutory development, balancing tests, and the opinions of experts in the field on both sides of the issue (including Commission consultants), as well as a general sense of what is permissible consumer protection in the present era.

The Commission's review of scores of cases has not led to any clear idea of what the governing standard might be. Most judicial discourse on the nature of the constitutional provision, the role of the Legislature in implementing it, and other affirmations of the sanctity of the mechanic's lien appear in cases involving technical issues or establishing the basis for a liberal, remedial interpretation of the statute. By and large, the cases are not concerned with limiting legislative power

69. 5 Cal. App. 4th 1264, 7 Cal. Rptr. 2d 456 (1992).

or rejecting legislative determinations of the proper balance of interests based on larger policy concerns.

The standard recitations pertaining to the force of the constitutional language suggest a general inclination of the courts to honor the protection of mechanics, suppliers, laborers, subcontractors, and contractors. But at the same time, it must be recognized that the concrete results in these cases have been largely to uphold statutory qualifications and policy balancing, notwithstanding the breadth of the constitutional language.